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Article Background

This essay was originally published in the Spring 1999 newsletter, one year before the tech stock crash began. The really important thing is that I remember is that the first paragraph was very difficult to write at the time.

Why? Because it seemed that very few people agreed with me. The popular conviction at the time was that Yahoo! and the other internet stocks actually were going to take over the world. People thought that experienced investment advisors who were staying away from internet stocks were missing the boat. People thought "the internet is different".

Ahh yes, this time was different. Last time it was real estate…

I recall thinking 'this may be your career here. If the internet stocks don't crash soon, you'll be toast'.

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What a stock bubble looks like

Here is a bold observation: "Today's internet-related stocks are in one of the greatest market bubbles of all time."
Here's why:

Yahoo! Is a company that helps people find things on the internet. Last year its sales increased dramatically to US$200 million. The sales increases have investors excited, to say the least. On January 8th investors were so excited the stock went up $40 to $415 per share. That's $40 in one day! Unfortunately, Yahoo! doesn't make any profits (yet).

At a price of $415 per share, the market value of the entire company is about US$41 billion. Yes, that's correct. Sales: $200 million, Profits: zero. Market value of entire company: $41 billion.

To give you some perspective, that's bigger than Boeing. It's bigger than Colgate Palmolive. Bigger than Kellogg. Bigger than Anheuser-Busch. Only difference is that Boeing, Colgate, Kellogg, and Anheuser-Busch all are large, very well run companies with well-established records. They also make profits. And they aren't going bust any time soon, so you can count on profits for a few years yet. So why are investors paying so much for Yahoo!? The reason, people tell me, is that Yahoo! will be a big, profitable company someday.

First, let me rudely interrupt with Sir John Templeton's advice: "The four most dangerous words in investing are, 'This time it's different.'"

Now let's look at the numbers. Let's assume that Yahoo! is able to become profitable, and becomes one of the most profitable companies on the planet, earning profits equal to 20% of sales. Let's also assume that the shares in the future are valued similarly to other very large, very profitable companies, and sell at a P/E ratio of 30. Your calculator will tell you that Yahoo! will need sales of $7 billion to generate a total market value of $41 billion. Now, for Yahoo! to get from $200 million in sales today to $7 billion will require earnings growth of 60% per year for seven years. It's possible, but not likely.

Another way to say this is that Yahoo! is selling today for 100 times the price that a normal, highly profitable company would sell for. Yet it makes no profit.

Yes, this time it is different. The Internet is big, and will be bigger in the future. Yes, some companies will figure out how to charge customers for using the Internet and will become profitable. But maybe it isn't different. We've seen speculative bubbles in the South Sea Company in Britain in 1720, tulip bulbs in Holland, stocks in 1929, the Nifty Fifty stocks in the 1960's, and gold in the 1970's. In all these instances, the market price collapsed.

The antidote? A portfolio custom-tailored to you and your family. Globally diversified investments including Europe, Asia, as well as the US. Professional investment managers whose style is to avoid the fads. And the patience to focus on your goals, not speculative bubbles.

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