Another tulip bulb, another dotcom

Was the start-up boom just another market craze – like tulip bulbs in the 1600s, Florida real estate in the early 1900s or biotechnology in the 1980s? An academic considers

The dotcom craze was not the first event of its kind. In fact, it is remarkably similar to the tulip-bulb craze of the early 1600s, the South Sea craze of the early 1700s, the Florida real-estate craze of the early 1900s, the Nifty Fifty [premier growth stocks such as IBM, Kodak, Disney] craze of the 1970s, and the biotechnology craze of the 1980s – to name but a few.

And, make no mistake about it, there will be some other craze, in some other industry, sooner or later.

Power suffixes such as “dotcom” and innovative metrics have been seen before. In the early 60s “-tron” (as in Vulcatron and Transitron) and “-onics” (as in Supronics and Videotonics) were the power suffixes of choice. Similarly, although “market cap per visitor” was one of the hot metrics on the Street this time around,

But it was so much fun on the way up! Chat rooms, day traders, new metrics, you name it. Any method or argument that could be used to justify an ever-increasing stock price was touted as the appropriate way to value new-economy stocks.

Misguided valuations The trouble started when even seasoned investors failed to handle relative valuations with care. They came to believe that value could be reliably assessed by multiples of visitors, or customers, or sales, instead of by multiples of earnings.

Investors were all too happy to accept a new metric of relative valuation that ascertained that company A was more expensive than company B: what they failed to understand was that both companies were wildly overvalued. The problem was not (as some pundis

An investor who bought Yahoo! in 1996 made a 993.1 PER CENT RETURN in less than 5 years

other ad-hoc measures, such as “product asset valuation” (an obscure method of estimating the value of a biotech company based on the value of the products in the company’s pipeline) have also been used before. And the list, of course, goes on: red-hot IPOs, sky-high P/Es, revolutionary technologies, celebrity analysts, hyper-bullish prospects... We’ve seen it all before.

would have it) that loss-making companies were given a high market cap. Stock prices, after all, do depend on expected cash flows. Rather, the problem was that the cash flows needed to justify the observed valuations were, in most cases, virtually impossible to attain. Cisco did double in size every year over a 15-year period. But start-up companies with nothing like Cisco’s brilliant track
record were priced as high as Cisco. There are several built-in mechanisms in the market that feed a bubble. On the upside, investors pour in, just about everybody in Wall Street manages to get a piece of the action and, next thing you know, it's a feeding frenzy. Nobody wants to spoil the party, of course, but no party lasts forever...

Stock shock. Just as investors were coming to believe that the stock market only goes up, all hell broke loose. On March 10 2000, the Nasdaq reached its all-time high of 5048.62, and it was all downhill from there. The market closed the year at 2470.52, losing 51.1 per cent from its peak – the worst performance in its 29-year history. The Goldman Sachs Internet Index was even worse: it peaked at 784.94 in March 2000 and closed the year at 181.64, down 76.9 per cent. In just nine months, almost $2 trillion, or $2,000bn (£1,386bn), of market value were wiped out.

Between March and December 2000, the bears came back with a vengeance. Glasses that were half-full were suddenly deemed to be half-empty, the irrational exuberance of markets became self-evident, and an army of analysts chanting “I told you so” marched on Wall Street.

Investors compounded their mistakes. Up until March last year, some reason could always be found for justifying the purchase of a wildly overvalued stock; after March, some reason could always be found to justify selling a stock, no matter its price. But here’s the rub – hard-to-justify optimism on the way up can turn to hard-to-justify pessimism on the way down, and did. Consider this. Amazon fell 85.4 per cent between its December 1999 high of $106.69 (£73.90) and its year-end close of $15.56 (£10.80). But an investor who bought Amazon at the offering price when it went public in May 1997 and held the stock through the end of the year 2000 made a 798.4 per cent return in less than four years. Not bad if you ask me.

Similarly, Yahoo! ended last year 87.3 per cent below its all-time high of $237.50 (£164.60). But an investor who bought Yahoo! at the offering price when it went public in April 1996 made a 993.1 per cent return in less than 5 years. Pretty impressive no matter how you slice it.

The Goldman Sachs Internet Index fell 76.9 per cent between its March 2000 all-time high of 784.94 and its December 2000 close of 181.64. But between its kick-off at 13.54 in July 1994 and its December 2000 close, it delivered a 1,241.5 per cent return in six and a half years. Hats off, please. So what have we learned? One way to answer this question is simply to say “not much”. This was a market craze, with a few distinctive characteristics (no two are alike, of course), but just another market craze after all. Still, investors may find it useful to keep these four lessons in mind:

Lesson 1. Next time you hear “This time it’s different”, run for cover. Most crazes started that way, and this one was no exception.

Lesson 2. “If it has a big impact on society, then it’s a good investment” is a lousy rule. Aviation changed the world but airlines have been a poor investment. “Do they have a sustainable competitive advantage?” is a far smarter question for an investor to ask.

Lesson 3. Don’t ask “Do they have a business model?” Ask “Do they have a good business model?” You can’t sell a dollar for 95 cents in the long term.

Lesson 4. Go back to basics. The value of a company has always been, is and will always be given by the present value of its reasonably estimated cash flows.

And as for me, well, next time MBA students voice doubts about the validity of the traditional valuation methods taught in corporate finance, I’ll have a new graph to show them what happens when investors dare to ignore a few inevitable truths.