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Where Do We Go from Here?

We have no quarrel with the Internet. On the contrary, it is probably the greatest communication and productivity enhancement since the development of the written word. We see the Internet quietly and immeasurably improving the profit margins of every company in which we invest. On a concrete basis, we see the Internet immediately boosting the revenues of Lucent Technologies, Hewlett Packard and Motorola as they sell equipment and services to companies offering Internet access. In addition, The Interpublic Group of Companies, our core global advertising holding, incorporates the Internet in all of its operations. In fact, "Adweek" included five of Interpublic's agencies in its rating of the nation's top Internet advertising shops.

While the Internet is definitely revolutionary, we believe that those who invest in Internet stocks are failing to ask the most fundamental of questions. The most important question is not "who will the Internet benefit?" (i.e., everyone), but "who will make money as a result?" The answer to the latter question remains elusive.

The paradox of Internet stock valuation is the absence of cash production by these companies. A key historical point here is that great capitalist ideas generate cash. Look at Henry Ford's automobile business or Tom Wolfe's books. The Internet, on the other hand, saves or eliminates cash. Just think about Amazon.com, which unprofitably ships books, videos and CD's to your house using our tax-subsidized postal service. If one thinks hard

about the future of the digital revolution, home videos and CD's (even books) will be made obsolete since their content will be downloaded directly to your TV or computer. Similarly, on an interim basis, why not order these items straight from the original music or book publisher in a year or two?

The current market speculation in the face of negligible or nonexistent earnings is so intense that traditional measures of value like P/E or "price to book" ratios have become absurd. What hasn't changed, in our view, is that "cash is king" and valuations of public companies will ultimately be driven by earnings.

To demonstrate the current speculative phenomenon, we note that the combined \$135.0 billion mar-

ket value of three Internet stocks (America Online, Amazon.com and Yahoo!) is the same as eight of our Core holdings (Interpublic Group of Companies, Alcoa, Illinois Tool Works, Automatic Data Processing, Consolidated Natural Gas, J. P. Morgan, State Street and Schlumberger). In other words, if you were to inherit \$135.0 billion, you could either buy the three Internet companies which have combined revenues of \$3.6 billion, or you could buy eight well-established Blue Chip companies with combined revenues of \$64.0 billion!

Looking at the math another way, The Interpublic Group of Companies has the same revenue and three times the net income as the combined Internet companies, but trades at a \$10.8 billion value versus \$135.0 billion for the Internet stocks. We suspect that if “.com” was added to Interpublic’s name, the stock would rise from \$75.00/share to \$3,000/share to reach parity with similar Internet companies.

Wild speculation in stocks is certainly not new. When the fitness craze hit in 1990, the company that owns Nordic Track saw its stock go from \$2.25 to \$34.00. Today, you can buy a share for less than a penny. The same thing happened to Cott Beverages in 1992 when it was thought that their private label soda was going to compete seriously with Coke and Pepsi. Cott’s stock went from \$4.00 a share to \$38.00 in one year, only to fall to today’s price of \$4.50. The Internet craze is far more dramatic than these two cases. Amazon.com has gone from \$1.00 to \$173.00 in two years and the company still has no idea as to when they might make money, though we suspect they acknowledge that postal rates are rising.

Adding to this speculative fever is the fact that the Internet itself is a vehicle for spreading speculative behavior. Institutional studies of block trading show that an abnormal amount of trading in these stocks is done by individuals. Congratulations to those who have profited and let’s hope that they speculate with money they can afford to lose.

So what are we doing for our clients in this environment? We have confidence that the benefits of the Internet will creep into every stock we own by way of increased productivity, higher profit margins and enhanced global growth. The losers in this battle may be retailers of “Internet-friendly” products. Incidentally, no retailers are on our Buy List.

We will continue to focus on companies that produce cash...not hype. Our goal is to preserve our clients’ capital and participate in “A Market in Full”, not one that may soon empty.

1994, the Disney bond lost almost 20% of it’s value when interest rates climbed. Large companies are issuing 100 year bonds again and our caution light remains bright. Also reminiscent of 1993, is leveraged speculation in the bond market and a hint of inflation. Our clients’ bond portfolios are comfortably invested in the 3-5 year maturity range and concentrated in bonds rated “A” or better. Moreover, we would much rather own stock in a company issuing a long term bond than the bond itself.

The American Consumer - One of the more puzzling phenomena today is the irony of weak consumer spending in the face of a stock market boom, low unemployment, low interest rates and economic growth. We attribute the current weak consumer confidence to a few factors. First, consumers overspent in 1994 on cars, homes and credit card purchases. During 1995, Frequent Flyer points were up and so were delinquencies. Secondly, some corporate restructuring continues (i.e., AT&T). Finally, and perhaps most importantly, the stalled budget negotiations have made many Americans nervous. Government employees, healthcare workers and beneficiaries of government spending such as Medicare/Medicaid recipients and not-for-profit organizations are justifiably anxious about the budget resolution. This uncertainty is causing millions of people (even those with jobs) to conserve their funds. However, we believe that a budget resolution, combined with the “wealth” effect from rising stock prices in

1995 will cause the consumer to come back in 1996 and beyond.

Conclusion: We feel strongly that stocks will outperform bonds in the coming decades. We favor multinational U.S. companies (J.P. Morgan, Merck, Boeing) which benefit from global growth. We also recommend exposure to companies such as Circuit City which will prosper should the U.S. consumer regain confidence in 1996. The markets will, however, remain susceptible to corrections... perhaps triggered by speculative bond positions and the reactions of short term institutional investors whose view of the long term is no longer than their daily commute to work. Our emphasis on quality and diversification should protect our clients during volatile times and allow them to participate over the coming decades in what may well be the best period of economic stability and growth ever witnessed.

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Hamilton Point Investment Advisors, LLC is a fee-based investment advisory firm suitable for high net worth individuals, not-for-profits, retirement plans and corporations. We welcome comments or questions and can be reached at (877) 636-3765, or e-mail us at aburns@hamilton-point.com.

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