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A Market in Full

Tom Wolfe's, "A Man in Full", is currently the nation's best selling novel. Compared to his "Bonfire of the Vanities" work years ago, which exposed the frailty of a wealthy bond trader on Wall Street, "A Man in Full" explores the experiences of an aggressive Southern real estate magnate. In both cases, an extreme focus on money makes for the rise and ultimate fall of the book's hero. If today's stock markets were a novel, a publisher would probably find some parts of the book downright "unbelievable.com". In fact, we believe that today's Internet stock appreciation may be the most effervescent speculation in history.

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 market 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.

Andrew C. Burns

President/Chief Investment Officer

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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