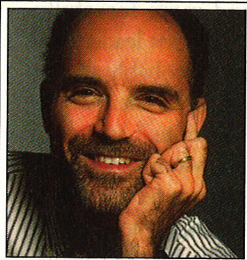


by Jason Zweig

baloney.com

Don't believe the hype about Internet stocks and funds.

For the next few months, perhaps even for a year or two, this may seem like one of the stupidest investing columns ever written. That's because I've been asked to answer the question "Can you get rich by buying an Internet stock fund?" and my answer is no. ✦ Yes, I know: The Internet Fund was up 196% in 1998 and another 84% through March; Munder NetNet Fund was up 98% last year and 42% more so far in 1999; and Monument Internet Fund, launched just last November, has returned 135% in its first four months of life.

Who can resist returns like these? Maybe no one, but I think you should. In the long run, the Internet stocks and the funds that buy them have no more chance of living up to their hype than Mike Tyson has of winning a Nobel Peace Prize. Many people investing in the Internet are basing their decision on a complete misunderstanding of how industries grow and investors prosper. The notion that a long-term investor can become rich simply by "buying early" into a revolutionary new industry—like the Internet—is flat-out wrong.

Of course that's not what the bulls say. At a recent conference on Internet stocks sponsored by PaineWebber, Greg Jones, chief executive of uBid, an Internet auction site, told me, "The Internet will change your life. It's the next frontier, as radio once was. This is the wave of the future, this is *the* business. You need to invest in the companies that will be part of the future."

And the people who invest in these companies are at least as bullish as the people who run them. "I firmly believe the Internet companies will be among the great growth companies of the future," says Monument Internet Fund co-manager David Kugler. "There's no stoppin' 'em."

But let's look at why Internet stocks are really so hot: It has less to do with their actual growth prospects than you may think. And let's see what past revolutions can tell us about this one.

The notion that you will get rich "buying early" is just wrong.

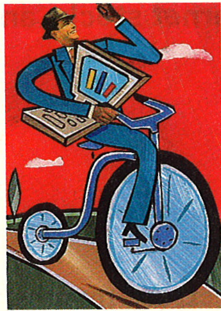
The thrill seekers

Peter Lynch, the legendary former manager of Fidelity Magellan Fund, has long advised investors to "buy what you know." Advocating "the amateur's edge" that comes from "the power of common knowledge," Lynch has famously recommended buying the stock of companies whose products or services you like. For instance, after his wife told him how great L'eggs pantyhose were, Lynch bought the stock. Likewise, with a few clicks of a mouse, you can buy books on Amazon.com; with just a couple more clicks, you can buy Amazon's stock through an online brokerage. "E-commerce" is easy, economical and exhilarating. And that's part of the reason so many people believe it's inevitable that Internet stocks will pay off big—and why they think their high prices are justified.

But as Lynch has pointed out, you can't just invest in what's familiar; you must also research it. There's a world of difference between a great company and a great stock. Just because you love shopping online doesn't mean that online retailers will turn out to be good investments. One big reason online shoppers love "e-tailers" so much is because their prices are low—so low, in fact, that it's not clear how some of these companies can ever turn a profit. That's great for you as a shopper—but maybe not as an investor.

Illustrations by Tom Garrett

Internet stocks are also hot because their share prices are so high and because of the throngs of thrill-seeking day-traders who chase them. If you've got $1,000 invested in a stock priced at $1, and it goes up to $2, you've doubled your money. But you probably won't be as excited as someone who has $1,000 invested in a stock that jumps from $100 to $200—even though you both have the same 100% gain. That's because people tend to focus on the absolute size of a price change, not its relative value. Because big price swings make it seem "something important and exciting has occurred," Harvard psychologist Paul Andreassen has written, "large price movements cause increased trading."



Will Internet stocks go the way of the wooden turnpikes?

And, as anybody who has ever been a teenager knows, people are much more willing to take risks when they're in groups than when they're alone. Marvin Zuckerman, a psychologist at the University of Delaware, has noted that merely joining a group of "sensation seekers" can make risks seem less scary—and that the worry of being seen as a wimp can become scarier than almost any physical or financial risk. That's why the visitors to online chat rooms and message boards egg one another on so wildly as Internet stocks surge up or down. And it helps explain why the price of these shares is so often divorced from their business prospects.

If only I had bought Microsoft...

Investors also have a bad habit of beating themselves up over past mistakes. How many times have you heard someone groan, "If only I had bought Microsoft when it went public..."? It now seems obvious that in 1986 Microsoft was sure to be a big winner. But in a series of brilliant experiments, psychologist Baruch Fischhoff of Carnegie Mellon University has shown that the knowledge of how an event actually turned out changes our original opinion of how likely it was to occur in the first place. Looking back, says Fischhoff, a given outcome seems "more likely than it actually was." Thus Microsoft now appears to have been a sure thing—but, in fact, it was considered a controversial and risky stock at the time, and many professional money managers wouldn't touch it until 1991.

Microsoft's spectacular gain makes picking long-term winners seem much easier than it really is, because it makes us forget that in 1986 several other companies, such as Novell and Borland, looked just as likely as Microsoft to dominate the software business. When you're looking for "the next Microsoft," you need to ask whether you could have recognized the *first* Microsoft. Most people—including most mutual fund managers—did not.

Don't know much about history

There's a phrase used by Internet bulls: "first-mover advantage." That's Netspeak for "the early bird catches the worm," and it expresses the belief that the companies that grow the biggest, the fastest—like, say, Amazon, AOL, eBay and Yahoo!—will obliterate the competition over time.

But 200 years of corporate history show that the early leaders in a dynamic industry almost never turn out to be the victors in the end. This is not some antiquated rule of how companies used to behave in the days when men wore powdered wigs and wooden dentures; it's more like a universal law that governs how companies evolve in any industry, at any time. Nor does the fact that everything moves faster on the Internet nullify this law; actually, the high velocity of "Net time" is likely to enforce this law of corporate destruction even faster and more forcefully.

"Thinking today's market leaders will prevail in the future is probably a great mistake—especially when their stocks are at such high valuations," says Alan Meckler, who runs www.internet.com, one of the best Websites for monitoring the online world, and who took his first Internet company, Mecklermedia, public five full years ago, raising $6 million—and then selling it last year for $274 million. Back in 1982, Meckler points out, two leading software programs were *Wordstar* and *Visicalc*—packages that ended up on the ash heap of computing history.

Time after time, history has shown it's the companies that come later—in our case, meaning Internet companies not yet extant—that end up making the real money. Far from being easy, the game of picking long-term winners among Internet stocks is probably as tough a challenge as any investor will face—so tough that most investors are doomed to fail.

Ye olde information superhighway

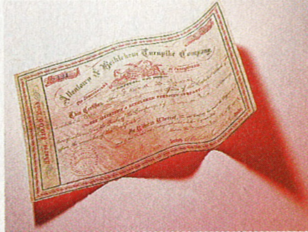
Today's information superhighway is all about moving data, goods and money—so let's compare the Internet to the first great wave of change in transportation. If you think the Internet has transformed human life more than anything else, here's some quick history. Before 1800, it took a week to travel from Boston to New York City over crude and crooked roads, and you would have arrived exhausted, aching and cloaked in dust. If you rode by coach instead of on horseback, you endured broken axles, shattered wheels and the ordeal of helping lift the wagon over ruts or out of mud.

Then came a quantum leap in transportation technology: turnpike companies that cleared straight, smooth swaths through the woods, laying down roadbeds of gravel or timber. These new highways struck many as one of the greatest improvements in the quality of life ever seen. Between most cities, the travel time was suddenly cut in half—with more comfort and safety. So great was the miracle of rapid transit that new

users of the turnpikes often burst into spontaneous prayers of gratitude when they arrived at their destination. By 1822, the cost of shipping a ton of goods had dropped from as high as 60¢ per mile to just 12¢—much as Amazon.com and Shopping.com are slashing prices today.

Over the corpses

Only a dunce could have looked at the phenomenal transformation the turnpikes had wrought and not have wanted to invest in them. And, in fact, they were the most popular stocks of their time. By 1800 two of every three companies in the U.S.—219 in all—were in the transport business, and by the end of the highway boom in the 1830s roughly 500 had sprung up. All told, investors put up roughly a billion dollars in today's money. The initial public offerings of the early transportation companies were often oversubscribed, with demand for shares often exceeding supply by nearly 100 to 1. Sound familiar?



After the railroads arrived, turnpike stock was worthless.

Unfortunately, while the turnpikes were incredibly beneficial for the people who used them, they were a disaster for the people who invested in them. Only six of New England's 230 turnpikes ended up earning positive long-term returns, and 3% to 5% a year turned out to be the best they could muster—at a time when government bonds yielded 5% to 7%. Price competition, then newer technologies like canals and steamboats (also hot stocks for a few years), crushed the rest of the turnpikes. Finally, around 1835, came the railroads, which not only finished the last of the turnpikes but put the canals and steamboats out of business too.

Most poignantly, the railroads were often able to lay their tracks with remarkable ease over readymade rights of way, through the clearings that had been made, years before, by the turnpikes. It's hard to think of a more poetic irony: The transportation revolution was consummated on top of the corpses of the companies that invented it.

Creative destruction

These waves of entrepreneurial energy and technological innovation—which Austrian economist Joseph Schumpeter called "creative destruction"—seem to apply to every newborn industry. Imagine that 90 years ago you had foreseen that the automobile industry, then in its infancy, would change the world. You would have been absolutely right—but your investments would have been absolutely wrong. You couldn't have bought Ford, even though the company was already 10 years old: Ford didn't go public until 1956. Chrysler did not yet exist. General Motors was only a year old.

Ron Saltiel

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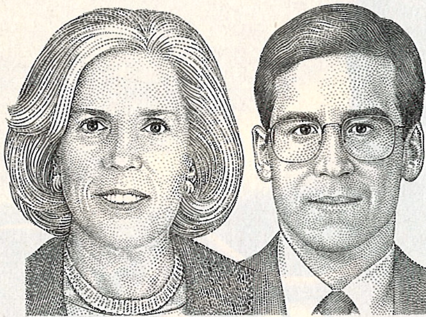

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