

## BOOK REVIEW ARTICLE

**The Internet Bubble Updated**

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*The Internet Bubble*, published during the information technology bull market, argued that internet stocks were overvalued. The article discusses the role of investors in one of the largest speculative run ups of history, discussing how the bubble occurred and some of the effects of its demise.

Key Words: Risk capital, venture capitalist, internet stocks, market capitalization, speculative

It has now become clear that the great run up in Internet stocks was a bubble. But in the middle of the bubble who had the courage to say so at the time, and to write a book so arguing. The answer is Anthony B. Perkins and Michael C. Perkins, writers for the investment magazine *Red Herring*. Their book is titled *The Internet Bubble* (Harper Business, 1999). While most books on new technologies and social trends have a gee whiz characteristic about them, with investment books on technology emphasizing the money to be made, here is a book emphasizing that these stocks had become overvalued, and even attempting to estimate by how much.

Vast fortunes have been made and lost in Internet stocks. It is now becoming clear that this was one of the great speculative run ups of all time, if not the greatest. The Perkins' provide an account of this episode and where much of the money was made. It is clear the fortunes were made by insiders; company founders, venture capitalists, and investment bankers, many institutional investors, as well as by some lucky outside investors. The losers appear to have been small individual investors who bought in at the wrong time.

Besides providing an account of the Internet mania, the book provides descriptions of key players and how they interacted to create and support the bubble. The process starts with an entrepreneur with an idea and the drive to convert this into a company. The examples

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discussed here are the well-known founders of Amazon and Yahoo. Creating a company requires capital. The venture capitalists provide this start up capital. How these venture capital firms emerged and how their financial basis shifted from wealthy individuals to institutional investors is described. The powerhouse firm of Kleiner Perkins Caulfield & Byers occupies a central place in the narrative.

The venture capitalist's goal is typically to develop a firm to the point where its stock can be sold to the public. The first time sale of stock to the public is referred to as an initial public offering (IPO). The growth of this business on the West Coast is described. Particularly fascinating is how Smith Barney sent Robertson there to prospect for business but then failed to accept the deals he located. This led him to set up his own firm, Robertson Stephens, specializing in underwriting IPO's for technology firms. Of course, eventually the big New York based firms did get interested in technology and now compete very vigorously for the business.

Unfortunately, one of the ways they compete for business is by promising analyst coverage of companies. Traditionally, the analysts job had been to provide investment advice for investors, both individual and institutional. Naturally such advisor is most useful if it is impartial. However, most of the brokerage firms are also investment banking firms which derive substantial revenue from selling stock to the public (their fee is typically 7% of the sales proceeds). Thus the analysts are under considerable pressure to say nice things about clients and potential clients. Not surprisingly, at a time when there were vast number of internet firms going public, and when many had business plans which would require additional sales of stock even after the initial public offering, analysts were generally unrealistically optimistic about the Internet. A 1998 Zacks Investment Research survey of analysts reports on 6,000 firms showed that only 1.4% got sell recommendations, while 67.5% were buys, and 31.1% holds. One of the major lessons for investors in this book is to be very suspicious brokerage firm analysts, and especially of those whose firms participated in the underwriting of a firm's stock.

The investors who were able to purchase stock at the opening made much of the money that was made in Internet stocks. During the boom the Internet stocks typically rose well above the offering price on the first day of trading. Since this was general knowledge, there was much competition to get an allotment of stocks at the opening. The investment banks get to chose who gets to purchase at the offering price (virtually guaranteeing the lucky purchasers a profit). The investment bankers, having something of value to allocate, have traditionally (and

rationally) allocated the new issues to their best customers, which were predominantly institutions, along with a few individual investors. To avoid having the price collapse too soon right after the offering, investment banks have normally tried to avoid selling an issue to those who planned to “flip” it, or sell it immediately after the issue. This is traditionally enforced against individuals by refusing to sell future IPO’s to investors who sell them immediately after the offering. However, according to this book the institutions are too important customers to take action against for flipping. As a result, many institutions made very good profits during the boom by being allocated a share of new issues and then immediately selling them.

However, there is another possible explanation for the more generous treatment of the institutions. Individuals hold their securities in an account with their broker. If shortly after purchase the individual sells the securities, the broker knows that and can easily put him on a blacklist for future initial IPO’s. Institutions traditionally have their securities held by a custodian, typically a bank. After purchase they are delivered to the bank. Institutions normally deal with multiple brokers. By the simple expedient of asking another broker who did not participate in the IPO selling syndicate to handle the sale of the shares, an institution can sell immediately after the offering without it being known to the broker that originally sold him the shares. Admittedly, the holdings of many institutions are made public periodically (for mutual funds twice a year) and investment bankers could look at these to determine if the stocks they had purchased were still being sold.

Because of the preferential ability of institutions to sell soon after a public offering, it is likely that much of the Internet Bubble profits were made by institutions rather than individual investors. Of course, individuals as holders of mutual funds or pension funds were the ultimate beneficiaries of many of these profitable institutional trades.

What is less defensible is the way some of the stock in hot public issues was allocated to the personal accounts of executives in firms that might some day be able to direct profitable business to the underwriters, typically when their own firms went public.

One reading this account of how firms are taken public is likely to conclude there is a better way. There is no obvious rationale for underpricing an issue and then allowing only a minority of those willing to buy at that price to actually purchase shares. It would seem much better to have a system that determined the market-clearing price and then sold the stock at this price.

Of course, the Internet bubble was not the first bubble and will probably not be the last. Other recent bubbles are discussed. The

introduction of the personal computer was viewed as revolutionary and it was accompanied by much speculative interest. Venture capitalists funded all sorts of computer related ventures. In fact, there were 43 different firms funded to produce disk drives between 1977 and 1983. Venture capitalists invested \$400 million in these companies. A bright future was forecast for each if only it could achieve 10% of the market. Of course, that goal sounded very modest for each firm taken individually, but it was unachievable for the new disk drive makers taken as a group and most were doomed to fail.

Another boom (the subject of a chapter) was in biotechnology stocks following the development of genetic engineering. In the end most of the companies in this field failed to realize their potential. By 1998 there were 350 public biotechnology companies and investors had put 90 billion dollars into these companies. Biotechnology companies had risen in only 7 of the last sixteen years (because such companies seldom pay dividends this indicates more losing than winning years). An investor who participated in every biotechnology initial public offering would have earned a return of only 1% per year.

While much money was lost in biotechnology stocks (as usual, venture capitalists and investment bankers made money), it could at least be argued that much useful research was done. New drugs were developed that will be benefiting people long after the patents have expired (see Robbins-Roth, 2000). Unfortunately, it is hard to make a similar argument for the numerous Internet companies that merely provided a better version of catalogue shopping or that provided consulting services in support of the industry.

Two journalists wrote this book. Thus, the reference list covers mainly the business press and popular books. Yet on some of the topics discussed there is a large academic literature. The reader of this book would get the correct impression that IPO's have been bad investments. However, the large academic literature that could document this impression is not mentioned.

Ritter (1991) examined the returns from 1,526 initial public offerings made between 1975 and 1984. The three-year return was 34.47%. A control sample of 1,526 firms matched for industry and size returned 61.86% over the same three years. Loughran (1993) examined the returns from 3,556 IPO's during 1967-1987 and found an average six year total return of 17.29% compared with 76.23% for the NASDAQ index during an identical period, showing results appreciably worse than Ritter had found for his three year tests. Later, Loughran & Ritter (1995) examined initial public offerings from 1970-1990. They found

that the average rate of return was only 5% per year for the five years after issuance, compared to 12 percent for firms of comparable size.

Building on my earlier work (Miller 1977), I just recently published (Miller 2001) a theory explaining these low returns. Essentially, prices are set by the most optimistic investors. The greater the disagreement about the true value of the stock, the further the opinion of the most optimistic investor is from the average opinion. Of course, since the future of new technology companies is very hard to forecast, there will normally be a great deal of uncertainty about their true values and much disagreement. This effect is possible even if on average estimates are correct. However, as shown by this book, the estimates for the Internet companies were far from unbiased, with the most extravagant claims being made. As Shiller (2000) points out this was a period of great optimism in the stock markets.

An appendix provides detailed calculations giving the market values for 133 internet stocks, each with market capitalization of over 100 million dollars, and their revenues along with estimates of how fast the companies would have to grow over the next five years to justify the current (June 11, 1999) prices. At that time, this portfolio had a market value of \$410 billion dollars based on combined sales of 15.2 billion (much of the sales came from only two companies, America on Line and Qwest) and with whopping losses of over \$3 billion. Only 22 of these companies actually showed profits. The Perkins close their book with an open letter to investors (titled "Sell now") saying Internet stocks are over-valued and urging, "If you hold any of these stocks, it is time to sell". If only investors had read this book and acted on this advice many billions would have been saved.

To see how prescient the Perkins were the portfolio management tool on the Yahoo web site was used to update the tables provided by Perkins. Naturally some companies have disappeared or merged since the Perkins did their calculations. The attached table shows the market capitalization for firms when the Perkins did their book and the market capitalization for the surviving firms as of July 24, 2001. As of July 24, 2001, 80 firms still existed and their market capitalization (i.e. the total value of the firm) had declined for most of the firms (market capitalization declined to less than 100 millions for 45 firms out of this surviving 80 firms). Interestingly, this collapse appears across the board with virtually no firms being worth more now than they worth in mid-1999. For two of these the greater valuation was due to mergers (America On Line and Earthlink). The three firms whose market values were still ahead of their mid-1999 values were Actuate, Verisign, and Vignette, three relatively small firms that are still worth slightly more

than they were worth in mid-1999. At the peak of the bubble many recognized that most firms would not make it, but argued that the winners would do well enough so that Internet investors could still show a nice profit. It now appears that investing in virtually any Internet stock during the peak of the bubble would have been a disaster.

The updating of the Perkins' analysis was done using the Yahoo portfolio tool. This makes it possible for the reader of this article to see the latest data on the surviving internet stocks. Anyone who wants to see the current capitalization for the surviving internet companies can go to <http://finance.yahoo.com> and log in with this user name: mithu\_uno and this: password: Amarsonamoni. Naturally some companies have disappeared (65 firms) or merged since the Perkins made their evaluations. The Appendix shows the market capitalization for firms when the Perkins did their book and the market capitalization for the surviving firms as of October 12, 2001. However, as of October 12, 2001, 68 firms still existed and their market capitalization (i.e. the total value of the firm) had declined for most of the firms. Interestingly, this collapse appears across the board with virtually no firms being worth more now than they worth in 1999 (except America Online, Actuate Corp., Verisign Inc. and Earthlink Inc.). This is important because at the time many investors recognized that many firms would not make it, but argued that the few winners would succeed well enough so that investors in Internet stocks could still show a nice profit. It now appears investing in virtually any Internet stock during the peak of the bubble would have been a disaster.

The market capitalization for American Online (AOL) and Earthlink Inc. are higher now because they are merged with Time Warner and Mindspring respectively. Excluding AOL the total capitalization of the surviving Internet firms was approximately 54 billion dollars on October 12, 2001. These same firms had a total capitalization of approximately 174 billion dollars on June 11, 1999. AOL (the most valuable internet company by far) is excluded because of its merger with the media giant, Times Warner. This greatly increased the size of the firm and would otherwise make the comparisons invalid. The table below classifies the firms by their function in the Internet economy (classified as Perkins did), showing the magnitude of the declines in each.

Besides the losses to individual investors, it is likely that society suffered from diverting risk capital from other fields. Robbins-Roth (2000) in her book on biotechnology (which has had its own bubbles), describes how venture capital for developing new drugs had virtually dried up because the venture capitalists were chasing the opportunities

to create new internet firms that could be taken public at a vast profit shortly after creation, while firms to create new drugs (a process that takes about a decade from idea to governmental approval) offered much lower returns. Yet as she points out, there is much more social benefit in life saving drugs than in new methods for selling dog food over the Internet.

### Comparison Between the Market Capitalization of the Surviving Companies

Group	June 11, 1999	Oct 12, 2001	% Lost of
	<u>Market Cap.</u>	<u>Market Cap.</u>	<u>Market Cap.</u>
	<i>In million dollars</i>	<i>In million dollars</i>	
Commerce	65,087.40	22,536.30	65.38%
Content*	41,486.50	10,306.40	75.16%
Enabling Services	18,629.10	1,888.00	89.87%
Enabling Software	26,639.10	16,081.70	39.63%
Enabling Telecom Service	21,922.70	3,147.00	85.65%
Total	173,764.80	53,959.40	68.95%

\* Excluding AOL

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## **Race, Marxism and the “Deconstruction” of the United Kingdom**

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Published in October 2000, *The Future of Multi-Ethnic Britain* is the latest, and to date, the most comprehensive, multicultural blueprint for the United Kingdom. Two assumptions are central to the report: first that race is a social and political construct not a biological or genetic reality; and second that the cultural homogeneity of the United Kingdom has been politically and socially constructed and can therefore be deconstructed only to be reconstituted into a multicultural/multiracial ‘community of communities’. This article examines the report’s position on national identity and history, racism, free speech and hate crime, education, the arts, media and immigration.

*Key words:* Arts, education, free speech, hate crime, history, immigration, Lenin, Macpherson Report, Magna Carta, Marxism-Leninism, multiculturalism, national identity, neo-Marxism, race-Marxism, Parekh Report, racism, anti-racism, rule of law, social and political construct, sovietization.

### **Introduction**

Cities and towns the length and breadth of Britain – from Bristol, the Medway towns, Slough and London in the south, to Birmingham and Leicester in the Midlands, to Bradford, Burnley, Edinburgh, Glasgow, Leeds, Oldham, Leicester and Manchester in the north – all now harbour large populations of non-white immigrants, a significant proportion of whom, for various reasons, refuse to or are unable to adapt to the host country. Over the last 20 years violent street confrontations between the native indigenous majority population and black and Asian immigrants have become depressingly familiar. In fact, racial strife is now a recognizable feature of the British urban landscape. Meanwhile, the numbers of legal and illegal immigrants entering the United Kingdom continue inexorably to rise. By any standards these are dramatic changes in an already densely populated and traditionally, racially homogenous country such as Britain. Given the failure of the British government to address the scale of the problem, it is reasonable to assume that the worst is still to come. And the problem is by no means confined to the United Kingdom. Similar and equally deleterious effects of legal and illegal immigration can be observed all over the Western world.

The native British population faces two threats from these changes, one immediate and on-going, the other a distinct possibility in the next

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