

CYBER-INVESTING: AN INTRO TO INTERNET STOCKS AS AN INVESTMENT

By Kenneth J. Michal

Internet stocks are much more volatile than the market as a whole, and this high level of volatility is directly associated with the substantial degree of valuation risk associated with many of the stocks of the industry.

Today, we are living and working within a technological revolution, and the Internet is playing a major role. It is a tool that is now used by millions almost every day, and not just as a means of keeping up with our investments. Computers and Internet connections have forever become an important part of life as we know it—like television.

With the development of this dynamic new medium of exchange and communication, new business ventures and opportunities have presented themselves and even given birth to brand new companies. As a result, an entirely new industry is emerging—the Internet industry.

This new Internet industry is a hot topic, and in the investment world that translates into hot stocks. Initial public offerings (IPOs) of Internet-based companies occur daily. Internet stock indexes are tracked by several firms and there are currently at least three mutual funds whose holdings are comprised exclusively of Internet stocks.

While this intense interest has generated a lot of heated discussions on individual “hot stocks,” there has been little in the way of insight or knowledge about the industry and the real investment opportunities available.

This article serves as a basic introduction to Internet stocks as an investment.

INVESTOR CONCERNS

The intrinsic value of the Internet is that it can bring information and knowledge to more people in a speedy fashion at little cost to the end-user. However, the intrinsic value of the Internet and Internet companies as an investment opportunity is unclear to many investors.

Investor concerns over Internet stock investing include:

- Wild price swings;
- High valuations in companies that have yet to post any earnings;
- The fear of getting caught in the crossfire of day traders that often target Internet stocks;
- Uncertainty over the ongoing Internet IPO boom that shows no signs of stopping; and
- Alarm over the huge sell-off of Internet stocks this past spring and summer.

Many of these investor concerns are justified, and an excellent example is found in the story of Netscape and America Online. Internet browser software manufacturer Netscape Communications went public in a widely publicized IPO on August 8, 1995; shares opened at \$35.50 on the first day of trading and closed at \$29.125. However, shareholders were subject to a roller coaster ride, including a high of \$83.75 in early 1996 and a low of \$10 in late 1998. Shareholders were rescued by AOL's buyout of Netscape, and Netscape shares went on to top-out at \$97.625 on their last day of trading, March 17, 1999, when the acquisition was completed (these prices are adjusted for a 2-for-1 split that occurred on February 7, 1996). In this example, internal fundamentals, increased competition, and overall market movements played a role in the downward spiral of Netscape shares, while the buyout brought Netscape back to higher ground. But being bailed out by

Kenneth J. Michal is associate editor of Computerized Investing.

a hungry buyer is not always the end result. The threat of volatility is ever present.

The volatility of Internet stocks as a group is illustrated in Figure 1, which plots year-to-date price performance of TheStreet.Com Internet index versus the S&P 500. This high level of volatility is directly associated with the substantial degree of valuation risk associated with many of the stocks of the industry.

In addition to these investment concerns, many investors have only a vague understanding of the industry. Common questions posed by many perplexed investors regarding Internet stocks are often along these lines:

- What is the Internet?
- What is an Internet stock?
- What are some examples of non-Internet stocks that can easily be confused as an Internet stock?
- How can I track and invest in the Internet industry?
- Is this the right type of investment for me?

WHAT IS THE INTERNET?

The Internet is a mass intercommunications medium. It essentially is a means of linking computer networks and individual computers. This network includes government, university, commercial, public, and private business computers and networks.

The Internet is sometimes better thought of as a set of standards or protocols that allow various types of computer networks to communicate with each other.

The protocol called TCP/IP enables communication between public and private networks running over any medium, including phone lines, traditional network lines, cable television wires, and even via wireless systems.

Currently, the popular protocols cover E-mail, Usenet newsgroups, file transfer protocol (FTP), and the World Wide Web (WWW)—the most popular method of navigating the Internet.

WHAT IS AN INTERNET STOCK?

In attempting to define an Internet stock, it is best to first draw some boundary lines, defining groups and sub-sectors.

Most Internet companies fall into one of two distinct groups—those companies that use the Internet as a means to sell or produce traditional goods and services, and those companies that produce a product or service that is used to construct and maintain the Internet infrastructure.

Another way to understand what constitutes an Internet stock is to establish sub-sectors in which to better categorize companies. We developed a group of stocks found in AAI's fundamental stock screening software program *Stock Investor Pro* that we believe fits the Internet stock mold. Most of these Internet stocks come from the technology sector, some from the services sector, and even some from the financial sector. The industries of this group, as detailed in *Stock*

FIGURE 1. THE STREET.COM INTERNET INDEX VS. THE S&P 500: RECENT PRICE PERFORMANCE

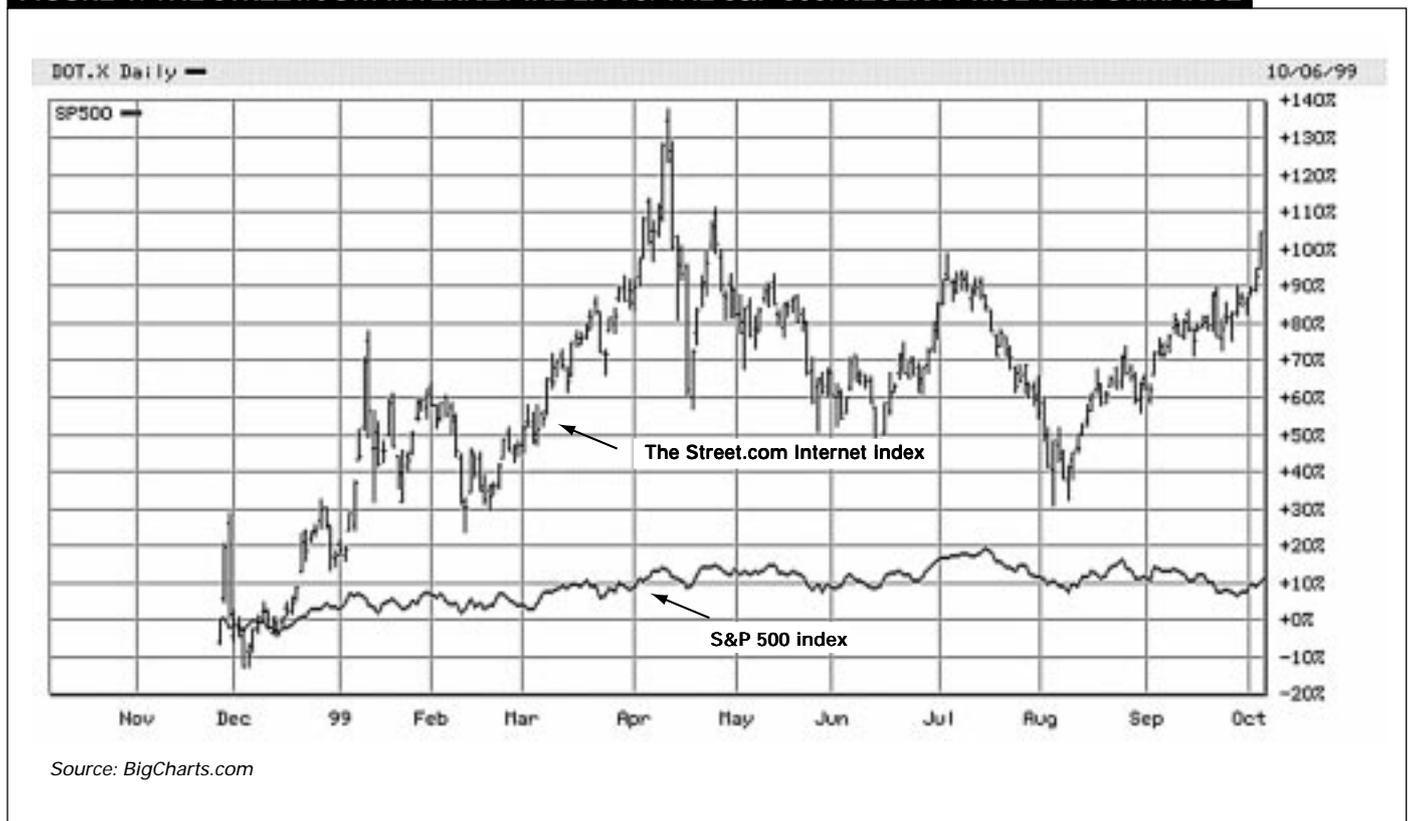


TABLE 1. INTERNET SUB-SECTORS AND REPRESENTATIVE STOCKS

Company (Exchange: Ticker)	Price (\$)	High Price 52-Wk (\$)	Low Price 52-Wk (\$)	Price Chng 13-Wk (%)	EPS Last Fiscal Year (\$)	EPS Est. Current Year (\$)	Est. Long-Term Grth Rate (%)	Market Cap (\$ mil)	Ann'l Rev. (\$ mil)
Auctions									
Bid.Com International (M: BIDS)	5.500	23.625	3.281	-32	-0.54	na	na	271.4	16.6
eBay, Inc. (M: EBAY)	138.219	234.000	8.417	-4	0.05	0.11	61.1	17,777.7	124.7
Hardware									
Aware, Inc. (M: AWRE)	27.875	87.125	4.625	-40	-0.11	0.18	30.0	604.2	16.3
Sun Microsystems, Inc. (M: SUNW)	92.000	95.750	19.500	31	1.35	1.71	20.4	71,810.9	11,726.2
Internet Advertising									
24/7 Media, Inc. (M: TFSM)	40.625	69.625	5.000	0	-2.62	-2.16	60.0	821.8	43.8
DoubleClick, Inc. (M:DCLK)	114.375	176.000	6.750	20	-0.57	-0.49	60.6	4,549.8	103.0
Internet Financial Services									
Charles Schwab Corp. (N: SCH)	32.563	77.500	10.282	-37	0.44	0.57	22.2	26,630.1	3,427.6
E*TRADE Group, Inc. (M:EGRP)	23.219	72.250	2.500	-42	0.00	-0.31	38.0	5,446.0	439.6
Internet Publishing									
MarketWatch.com, Inc. (M:MKTW)	49.313	130.000	26.125	-7	-1.38	-2.97	62.5	678.2	12.2
TheStreet.com (M:TSCM)	17.969	70.125	15.188	-44	-1.73	-1.40	50.0	440.4	7.9
Internet Retailing									
Amazon.com (M:AMZN)	77.250	110.625	13.333	25	-0.42	-0.94	72.3	26,049.0	1,014.7
eToys, Inc. (M:ETYS)	65.500	83.563	28.125	53	-0.85	-1.12	50.0	7,525.4	37.6
ISP/Hosting									
America Online, Inc. (N: AOL)	107.875	175.500	20.625	-6	0.73	0.61	50.8	119,534.1	4,777.0
Exodus Communications (M:EXDS)	69.125	89.750	3.875	16	-1.09	-1.10	73.5	5,690.4	108.2
Multimedia									
Launch Media, Inc. (M:LAUN)	11.625	36.688	7.875	-34	-16.36	-2.72	na	147.3	8.0
RealNetworks, Inc. (M:RNWK)	106.250	131.875	11.063	18	-0.25	0.07	51.7	7,756.5	88.7
Portal									
At Home Corp (M: ATHM)	40.969	53.250	12.625	4	0.51	0.73	32.1	1,755.6	166.4
Yahoo! Inc. (M:YHOO)	175.438	244.000	48.750	-2	0.14	0.35	53.6	45,437.6	340.9
Security									
RSA Security, Inc. (M:RSAS)	27.813	30.625	5.438	29	0.72	0.67	33.5	1,080.9	188.2
VeriSign, Inc. (M:VRSN)	104.344	117.750	9.688	23	-0.47	0.03	107.6	5,283.8	58.0
Software									
Macromedia, Inc. (M:MACR)	40.969	53.250	12.625	4	0.51	0.73	32.1	1,755.6	166.4
Spyglass, Inc. (M:SPYG)	11.813	32.250	8.625	-40	-0.60	-0.13	40.0	195.2	26.3
Training/Education									
Prosoft Training.com (M:POSO)	3.938	5.000	1.000	75	-1.48	0.04	na	54.6	8.7

Exchange Key: N = New York Stock Exchange
A = American Stock Exchange
M = Nasdaq

Source: AAI Stock Investor Pro/Market Guide, Inc. and I/B/E/S. Data as of October 2, 1999.

Investor Pro, range from apparel/accessories to healthcare facilities to several retail industries. As one would expect, the communications services, computer services, and software and programming industries dominate this group of stocks.

These industry classes were helpful

in determining the nature of some of the stocks, but a closer look at each company's business model proved to be the best criterion for entry into our exclusive Internet list. Using the most popular business lines, we then came up with 12 special sub-sectors for the stocks of the Internet indus-

try—auctions, hardware, Internet advertising, Internet financial services, Internet publishing, Internet retailing, Internet service provider (ISP)/hosting, multimedia, portal, security, software, and training/education.

Table 1 breaks down each of

the 12 Internet stock sub-sectors and lists a few stocks for each group, along with their investment characteristics.

THE E-COMMERCE DEBATE

At first glance, it would appear that one sector is missing from this list of 12 sub-sectors: the all-encompassing "E-commerce." E-commerce, or E-business, is one of the many popular catch-phrases born of the Internet. It refers to any retail business conducted on-line. However, for our purposes "E-commerce" is too broad a term to be considered an Internet sub-sector.

As an example of the dilemma, take on-line retail maven Amazon.com, and eBay, the on-line auction house. Both of these companies are indeed Internet stocks, but they have very different strategies for making money.

Amazon.com is akin to a combination book, movie, and music store on the Web, although it does now offer auctions. However, its primary source of revenue is as a pure retail operation: It must acquire, store, and dispense its inventory.

eBay is an on-line auction house that uses its Web platform to reach more people, bringing more buyers and sellers together, and offering a more diverse mix of items. With eBay, the retail selling of goods and services is nonexistent. eBay makes its money off of fees charged for hosting the on-line auctions. eBay does not directly handle any of the merchandise.

Which of these is an E-commerce business? You could argue either way, but the best answer is to have an Internet retailing sub-sector for the likes of Amazon.com, CDnow, and eToys, and an auction sub-sector for eBay and Bid.com.

WHICH STOCKS DON'T COUNT?

There are some companies that are in the technology and computer sectors that are thought of as being

part of the Internet industry, when they are in fact not even close.

When looking at stocks in terms of financial age or maturity, pure-play Internet stocks are quite frequently characterized as new, emerging companies with limited financial histories.

However, when researching Internet stocks, you will often find larger, more mature technology companies (mature in comparison to the pure-play Internet stock listings) thrown in with Internet stocks—whether it be in Internet indexes or as part of the holdings of an Internet fund. This often is because a segment of these tech companies, say the operations of a sub-division or a whole subsidiary, is in the Internet.

A good example of a larger company that has a segment of its business in the Internet is Microsoft. Microsoft markets and manufactures Internet Explorer browser software and software to create, manage, and populate Web sites; offers its own Internet service provider (MSN); and hosts numerous sites on the Web. But its primary business operations

are in computer software. Microsoft as a company has a powerful hand in the Internet industry, but its stock is not a pure Internet play.

Creative Technologies, Dell Computer, Qwest Communications, and Symantec are other companies that are also sometimes mistaken for Internet stocks.

Sectors whose companies often find themselves amongst the Internet stocks include: computer networks (3Com, Cisco Systems, Novell), communications equipment (Lucent Technologies), semiconductors (Intel), broadcasting & cable TV (CBS, USA Networks), and even motion pictures (Time Warner). These are clearly examples of companies benefiting from the Internet, but not pure Internet stocks.

The best way to understand which do and which do not belong in the Internet economy is to research a company's business model and try to place it in one of the sub-sectors listed here. If the company does not fit into one of the 12 sub-sectors, it is probably not a pure-play Internet stock.

TABLE 2. INTERNET INDEXES

Dow Jones Internet Index

www.dowjones.com

averages.dowjones.com

The new DowJones.com Web site features an Internet stock index: the Dow Jones Internet composite index, consisting of 40 Internet stocks—15 from an E-commerce index and 25 from an Internet service index. The composite index is weighted by market capitalization, except for a ceiling imposed on the very largest stocks. This cap is limited to no more than 10% of either the E-commerce index or the Internet services index. The Dow Jones Internet composite index dates back to June 30, 1997.

TheStreet.com Internet Index

www.thestreet.com

The most popular Internet stock index, featured in the weekly Internet industry publication "The Industry Standard" and often quoted in stories about Internet stocks. It tracks 20 major Internet companies, and is an equal-weighted measure of their performance. Users can get a quote on this index using the ticker symbol DOT.X.

ZDNet Inter@ctive Investor @Net Internet Index

www.zdii.com

This index is one of several industry indexes tracked by ZDNet, and is currently comprised of 46 Internet stocks. A quote for the index can be accessed at the site as well as price and volume data for each of the stocks in the index.

TABLE 3. INTERNET INVESTMENT VEHICLES

MUTUAL FUNDS	TRUSTS
<p>The Internet Fund Ticker: WWFX www.theInternetfund.com (888) 386-3999</p>	<p>Merrill Lynch's Internet Holders www.ml.com Full service brokerage firm Merrill Lynch just unveiled a new Internet trust called Internet Holders, similar to a Standard & Poor's depository receipt (SPDRs), or Spider. In this trust, the shares of 20 of the largest Internet stocks are held in trust, for which The Bank of New York serves as the trustee. Internet Holders is weighted by market capitalization, with such firms as America Online, Yahoo, and Amazon.com representing the largest stakes. This trust, termed a "cyberspider," trades under the ticker symbol HHH.</p>
<p>The Monument Internet Fund Ticker: MFITX www.monumentfunds.com (888) 420-9950</p>	
<p>The Munder NetNet Fund Ticker: MNNA netnet.munder.com (800) 438-5789</p>	
<p>WWW Internet Fund Ticker: WWIFX www.Internetfund.com (888) 263-2204</p>	
<p>The Internet 100 Fund www.Internet100fund.com (877) 655-1110</p>	

TRACKING INTERNET STOCKS

Popular indexes that track the performance of Internet stocks are listed in Table 2, along with information on how to access the indexes. The indexes are helpful in tracking the performance of the sector and gauging the performance of your Internet picks or that of a fund manager. These Internet indexes include: the Internet content publisher, ZDNet's index; an index from the on-line arm of Dow Jones; and an index tracked by the popular market news and commentary site TheStreet.com.

INTERNET MUTUAL FUNDS

While the volatility of Internet stocks is very high, the potential volatility of a single Internet stock is even higher. An investment in a portfolio of stocks increases the odds of participating in the broad movement of Internet stocks, while reducing the risk of owning a single issue. Investors can build their own portfolios, or invest in a diversified portfolio of Internet stocks using a mutual fund or investment trust.

Table 3 is a listing of Internet investment vehicles, including their Web addresses. The Web sites of the

these mutual funds also serve as a valuable resource for investing in the Internet arena.

The table lists mutual funds whose holdings are comprised completely of Internet stocks. One note: The Internet 100 Fund is a very small fund and is not currently quoted on the Nasdaq mutual fund listing.

The lone Internet trust instrument listed is from Merrill Lynch; this trust is termed a "cyberspider" and trades under the name Internet Holders (ticker: HHH).

DOES IT FIT YOUR PROFILE?

What type of investor is best suited for Internet stock investing?

It is clear that investing in individual Internet stocks is a risky undertaking for only the most aggressive of investors. Some of the risk, however, can be reduced by investing in a portfolio of Internet stocks, although the industry as a whole is clearly very volatile, as was illustrated in Figure 1.

If you can tolerate the risk associated with an aggressive investor profile, then perhaps Internet stocks are for you. But do not go into any Internet investment blindly—research the company thoroughly, reviewing company fundamentals in-depth.

Cutting through the dense brush of the Internet jungle with the tools of research will help clear a path to the truth behind any stock. ♦