# Bubble Lessons: Dot-com Déjà Vu

**February 17, 2021**

At times, the young, inexperienced investor can be fearless, like a 5-year old strapping on a pair of skis. The late ‘90s technology bubble was one of those times. The average Robinhood customer was just 10, too early to heed its lessons. Even though the typical baby boomer (in his prime earning years) had to be carried off the mountain in a stretcher, those broken bones have healed and painful memories largely faded with the 12-year bull market.

What was it like? As a contrarian, value investor and short seller, several words come to mind: brutal, miserable, relentless and never ending. My investment firm was stuck in Old Economy value stocks. We were dinosaurs marked for extinction, our collective IQs heading lower with every new high in the NASDAQ. Clients left for greener pastures. Neighbors started investment clubs. Friends shared investments tips, like “buy AOL.” Stockbrokers peddling the New Economy wouldn’t allow their daughters to date a tech bear (true story).

“History doesn’t repeat itself – at best it sometimes rhymes,” said Mark Twain, perhaps anticipating the post-1971 Bretton Woods era of serial bubbles. Parallels to the current mania are uncanny, yet the differences worth noting.

**Oh yeah?**

In 1931, Edward Angly published a collection of quotes from leading authorities about the boom, crash and early bust from 1928-1931 titled, *Oh Yeah?*. In that spirit, a compilation of comments and magazine covers should bring to life the giddiness of 1999-2000:

“This book will give you a completely different perspective on stocks. It will tell you what they are really worth - and give you the confidence to buy, hold, and profit from your investments. It will convince you of the single most important fact about stocks at the dawn of the twenty-first century: They are cheap.”

> ~ James K. Glassman and Kevin A. Hassett, *Dow 36,000: The New Strategy For Profiting From the Coming Rise in the Stock Market* (1999)

September 6, 1999

September 27, 1999

"I just want to point out that there is robust change. I hear this stuff all the time, about how it is a bubble, it's ridiculous."

~ Art Samberg, Pequot Capital Management, Barron's Roundtable, January 24, 2000

"If you know anything at all about the Internet, you know you can practically live your life without ever leaving your computer. You can order books without ever going to the bookstore, reserve airline tickets, even buy food for your house pet. That's the 20th century; in other words, yesterday. The new stuff is percolating out of a bunch of old buildings in downtown Manhattan, and the people who work there call themselves 'the dot-com kids.' They're cool, they're hip, they're very rich and very young... Their motto could be "Never invest in anyone over 30.'"

~ Bob Simon, "The Dot-Com Kids," *60 Minutes*, February 15, 2000

January 31, 2000

February 14, 2000

"This correction will run its course until the middle of the year. Then things will turn up again, because not even Greenspan can stop the Internet economy."

~ Larry Kudlow, February 25, 2000

"You want my top 10 stocks for who is going to make it in the New World?... OK. Here goes. Write them down -- no handouts here!: 724 Solutions, Ariba, Digital Island, Exodus, InfoSpace.com, Inktomi, Mercury Interactive, Sonera, VeriSign, and Veritas Software. You have to throw out all the matrices and formulas and texts that existed before the Web... If we use any of what Graham and Dodd teach us, we wouldn't have a dime under management."

~ Jim Cramer, "Winners of the New World" speech, February 29, 2000

"Look, I think tech stocks are innocent until proven guilty. If Veritas is growing earnings 40-50% and Gillette is growing earnings at only 1.5%, is Veritas worth 20 times the multiple Gillette has? I don't know, maybe so."

~ Tom Galvin, chief investment strategist, Donaldson Lufkin & Jenrette, April 24, 2000

"From where did this loony idea emerge that a cowlicked midwesterner who buys stock in companies that turn out syrupy fizz water, bland ice milk and lefty newspapers should thus be known as a Value Investor?... Tech will roar back. It will continue its merry dash toward infinite powers at zero cost. It will transform all in its path. Markets may (and just did) correct for overvalue, but they can't abjure the laws of physics... Bottom line: In such an explosive economy, there will be no safe harbors for traditional 'value' stocks."

~ Rich Karlgaard, publisher, *Forbes*, May 2000

"I have never been more optimistic. There are no changes to guidance."

~ John Chambers, CEO, Cisco Systems, remarks made at analyst meeting, early December, 2000

"I am assuming this will be a very short-lived slowdown because policy makers have significant tools at their disposal. The Federal Reserve in adjusting rates last week stood up and said, 'We are watching and will do more if necessary.' That serves as a confidence builder."

~ Abby Joseph Cohen, chief strategist, Goldman Sachs, January 15, 2001

**Déjà vu all over again**

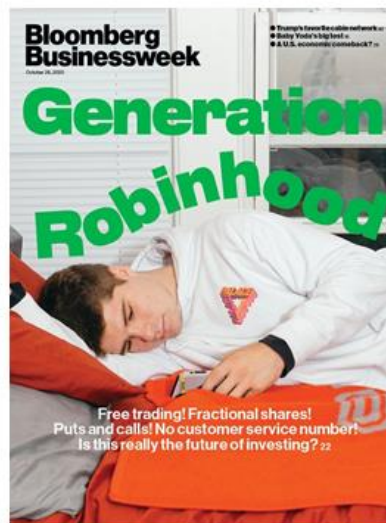
The frenetic energy of today's everything bubble has an all too familiar feel. A number of technological revolutions are taking place, rewarding youth and daring while punishing experience and caution. For those who "get it," business expansion and stock riches are limitless while online trading delivers the fruits of human progress to the average person. In a recent cover article, "The real Wall Street revolution," *The Economist* gushed,

> Information technology is being used to make trading free, shift information flows and catalyse new business models, transforming how markets work. And, despite the clamour of recent weeks, this promises to bring big long-term benefits.

According to *Barron's*, the retail investor has arrived:

> In the past year, more new investors have opened accounts at brokers than ever before. U.S. brokers added at least 10 million new retail trading accounts, and a shift to zero trading commissions late in 2019 unlocked a wave of activity that dwarfed even the wild days of the dot-com bubble.

February 22, 1999




October 26, 2020

*Gurus*

Another familiar ring is the emergence of star fund managers. In 2020, over two dozen funds sported triple digit returns, five of them from Cathie Wood's Ark Investment Management. Assets under management at Ark have gone from $3.2 billion at the beginning of 2020 to $57.6 billion (Ark's ETFs experienced inflows of $36.6 billion over that time).

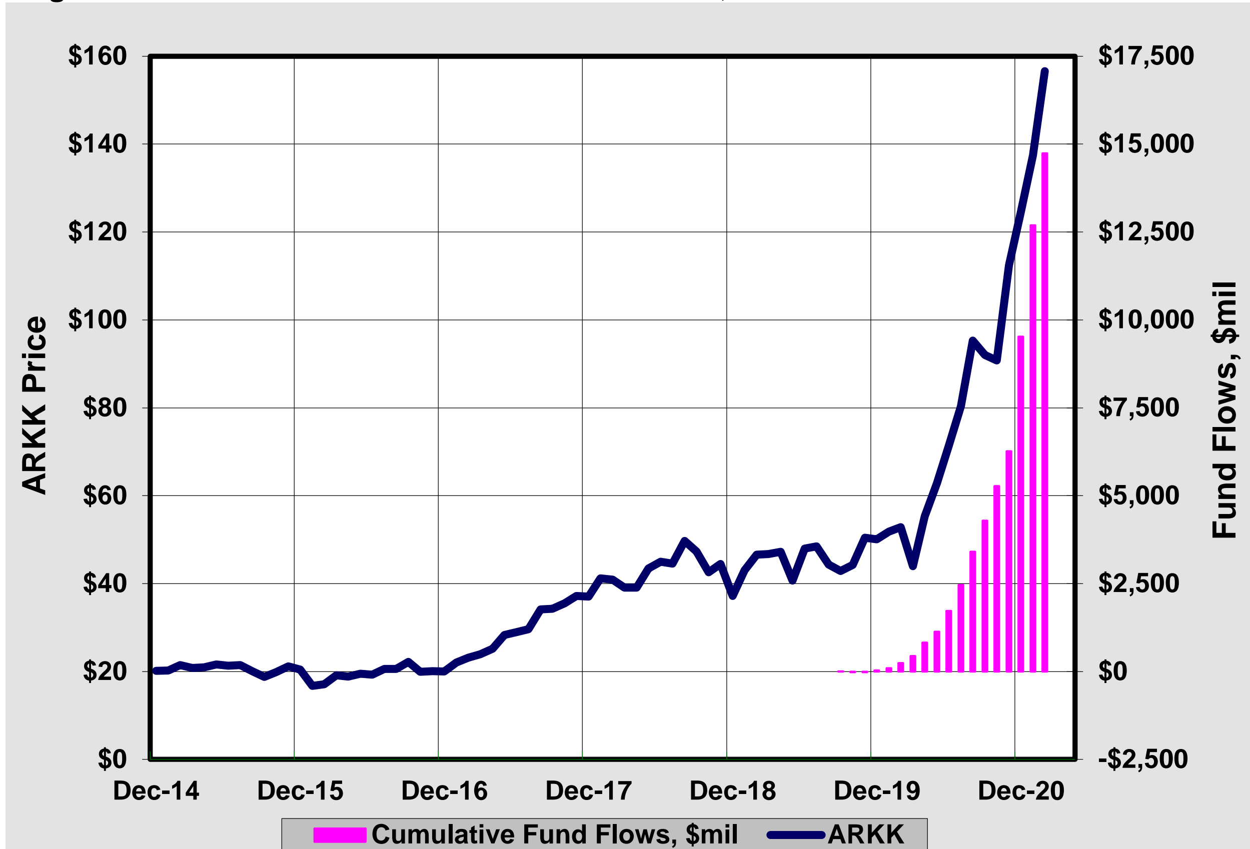
In 1999, Garrett Van Wagoner was treated like a rock star. His Van Wagoner Emerging Growth Fund was up 291% that year and assets went from $189 million to $1.5 billion as money poured in. The dot-com bust was not kind: Emerging Growth lost 89% in three years and assets dropped to $100 million.

Cathie Wood, 65, seems oblivious to any parallels:

> What's fascinating about this period is that now we're seeing a flood of IPOs, a flood of secondaries, we've seen SPACs, which really are liquidity events earlier than otherwise might have taken place, because I think there's a collective understanding that the future is here. And if we don't invest now, we're going to lose out... So we've got five platforms, 14 different technologies. We've never seen this amount of change at the same time in history.

Meanwhile, ARK Innovation (ARKK) is now the largest actively managed ETF (see Figure 1). In January, Ark filed plans to launch ARK Space ETF (ARKX) to "primarily track U.S. and global companies engaged in space exploration and innovation."

**Figure 1: Cumulative ETF Flows – ARK Innovation, 2015-2021**

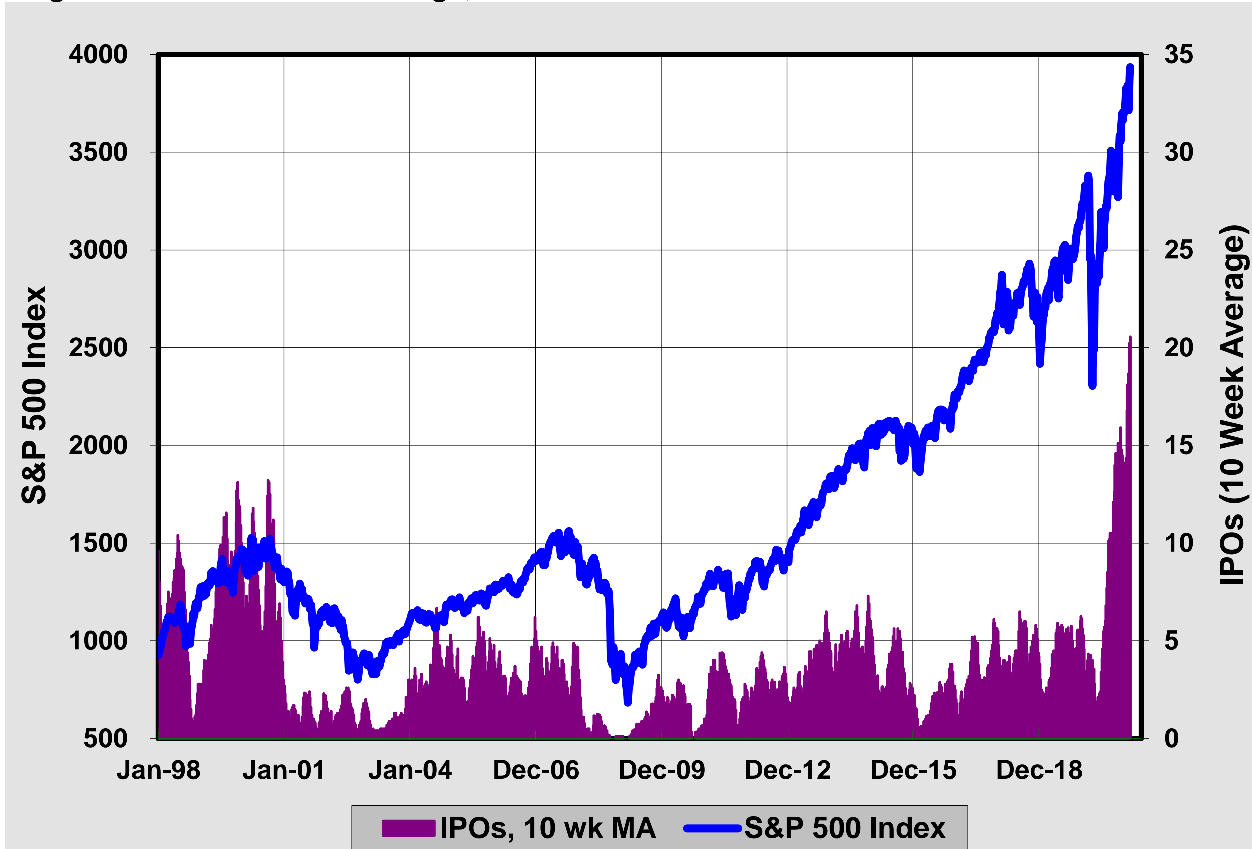



*Source: ETF.com*

*Initial public offerings*

Speaking of equity issuance, the current IPO boom is another throwback to the late '90s. Over the past 10 weeks, over 20 companies have gone public on average, nearly double the pace at the March 2000 NASDAQ peak (see Figure 2). Large first-day pops are commonplace. Over the past week, 19 companies went public in the U.S., 7 of which were SPACs (special purpose acquisition companies). The non-SPAC group gained an average 57.6% on the first day of trading. According to Jay Ritter, finance professor at the University of Florida, the 1999 and 2000 IPO vintages averaged first-day returns of 70.0% and 56.1% respectively. Earnings quality is unusually low: In 2020, 80% of IPOs had negative earnings, in line with the 2000 crop.

**Figure 2: Initial Public Offerings, 1998-2021**




*Source: Barron's*

*Valuations*

Comparing valuations of different eras is difficult at best, like comparing Michael Jordan to Wilt Chamberlain. Interest rates were much higher in 2000 and the makeup of the public markets very different. One method is to examine similar companies.

Cisco Systems was the posterchild for large cap growth in 2000, led by CEO John Chambers, dubbed "Mr. Sunshine" by Fred Hickey for his eternally upbeat demeanor. Its present day counterpart is Tesla, driven by Elon Musk: brash, visionary and fabulously wealthy (the richest man on the planet despite barely turning a profit). By virtually any valuation metric, Cisco at its peak couldn't light a candle to Tesla today (see Figure 3).

**Figure 3: A Tale of Two Growth Stocks**

| Indicator | Cisco Systems March 2000 | Tesla February 2021 |
|---|---|---|
| Stock Price | $77.31 | $816.12 |
| Enterprise Value, $Bil | 571.1 | 922.1 |
| Annual Gross Profit, $Bil | 9.7 | 6.6 |
| Annual R&D, $Bil | 2.2 | 1.5 |

| EV/Gross Profit | 58.80 | 139.08 |
|---|---|---|
| EV/R&D | 261.5 | 618.4 |
| 5-Year Gross Profit Growth | +54.7%/yr | +48.3%/yr |
| 5-Year Shareholder Growth[1] | +41.8%/yr | +34.2%/yr |
| 5-Year Share Count | +8.5%/yr | +11.4%/yr |
| Annual Operating Margin | 62.8% | 6.3%<br>(1.3% excl. auto credits) |

*Source: SEC EDGAR*

1. 5-year shareholder growth = debt-adjusted growth in annual gross profit per share

*Inflation*

Both bubbles coincided with commodity busts which put a lid on price inflation while giving cover to central bankers to inflate asset prices. As Jim Grant wrote on July 30, 1999:

> During the Cold War, Russia was a major raw materials consumer and a minor exporter. Today, it consumes little and exports much. The creditors of the world owe more than they know to this transformation… It has helped to bring about the persistent commodity bear market, a phenomenon that has silently contributed to the reputation for genius of the Federal Reserve Board.

As recently as April 2019, *Bloomberg Businessweek* asked on its cover, "Is Inflation Dead?" Investors are increasingly purging resource stocks during this cycle for ideological reasons.

March 6, 1999

May 4, 2020

*Anti-bubble*

2000 was a classic sector bubble. At the end of February, 82.4% of Fidelity's sector fund assets were in technology and biotechnology, up from 36.7% two years earlier. In the final 6-month run-up, investors dumped value stocks in order to buy more dot-com lottery tickets, creating a massive anti-bubble. In

fact, the performance and valuation profile of equities looked like a geyser next to Lake Superior (very deep) and most value stocks *bottomed* in March 2000, mirroring the NASDAQ peak.

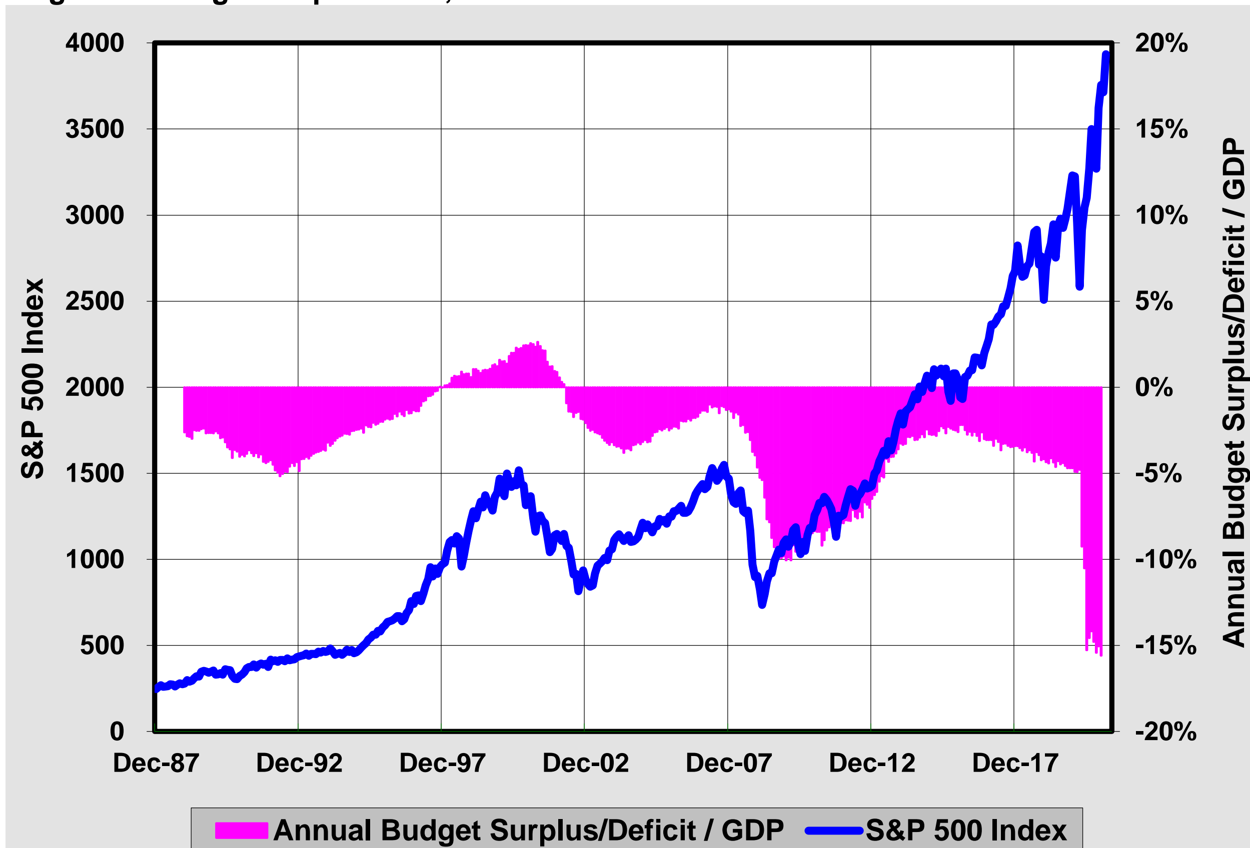
Sentiment was a mix of euphoria for the winners and gloom for the losers. For those few who actually cared about value, there were plenty of places to hide, e.g. bonds, REITs, equity income, small cap value and resource stocks. The 10-year Treasury yielded 6% next to an S&P 500 yield of 1%.

The bubble today is much greater ("everything") and the anti-bubble far smaller. There are still places to hide, e.g. precious metals, commodities and stocks across the "index divide." With the 10-year yielding just 1.2% and price inflation creeping higher, bonds are no longer a safe portfolio diversifier. Before the recent correction, 30% of global bonds sported negative yields ($18.5 trillion) and another 45% yielded between 0% and 1%.

**"It's different this time"**

There are significant differences, of course, the biggest being the state of the economy. Debt, deficits, and money printing today make 2000 look like child's play. In fact, the tech bubble inflated the government's coffers enough to produce its last budget surplus (at least using flawed cash accounting) (see Figure 4).

**Figure 4: Budget Surplus/GDP, 1988-2021**




*Source: Federal Reserve Economic Data (FRED)*

Lessons have been learned along the way, but unfortunately the wrong ones. Central bankers learned not to prick a bubble by raising short-term rates. Investors learned never to second-guess the Fed and to turn a blind eye to economic fundamentals. Serial bubbles of the past two decades have hollowed out the real economy while driving a wedge between asset owners and the rest of the population. Among the young, there is a sense of anger and desperation; sadly, many are now reacting by joining the party and throwing caution to the wind.

Another key lesson from 2000 is that virtually nobody got it right. The tech bust vindicated the bears, at least for a brief three year period, but the promise of the internet was ultimately borne out, exceeding expectations of even the most wide-eyed optimists. Yet few of the early dot-com pioneers survived the shakeout to reap the rewards.

Similarly, the unwinding of the bubble in current form is likely to confound. Could rising long-term rates, largely outside the control of central bankers, be the proverbial pin? Will the Big Tech trees succumb to a new wave of disruption, punishing investors, but reinvigorating the economy or will they tower over and choke off growth? Could they rot from within due to cancel culture and toxic ideology? Far more than in 2000, Big Tech *is* the economy and will not escape a serious downturn.

Any crash, whether in nominal or real terms, will create a new set of victims and have serious repercussions. Will the millennial generation swear off equities? Will they lash out at the rich and vent their anger on whatever remnants of capitalism still exist?

In early 2021, there are more bells ringing than at a pre-Covid Austrian downhill. Novice investors are perched at the top of a mountain staring down a double-black diamond. Beginners take ski lessons for a reason. Perhaps the first class should involve studying the late 1990s.

**Figure 5: A Tale of Two Bubbles**

| Indicator | March 2000 | February 2021 |
|---|---|---|
| S&P 500 | 1498.58 | 3934.83 |
| Gold | $276.75/oz. | $1816.35/oz. |
| 10-Year Treasury Yield | 6.02% | 1.20% |
| CME BofA High Yield Index | 12.08% | 4.09% |
| S&P 500 Dividend Yield | 0.99% | 1.45% |
| VIX | 23.67 | 19.97 |
| Investors Intelligence Poll Bulls - Bears | +25.7% | +40.5% |
| Barron's Intermediate-Best Grade Bond Spread | +0.55% | +1.23% |
| Consumer Confidence Index | 137.1 | 89.3 |

| | | |
|---|---|---|
| AAII Cash Allocation | 15.0% | 15.4% |
| Initial Public Offerings 10-Week Average | 11.5 | 20.6 |
| Secondary Offerings 10-Week Average | 7.7 | 27.4 |
| MMF / (Mutual Fund + ETF Assets) | 23.1% | 14.8% |
| Equity Mutual Fund Cash Levels | 4.0% | 1.9% |
| Schwab Client Cash | 13.4% | 12.3% |
| Margin Debt, 6-Month Change | +58.1% | +33.1% |
| Margin Debt / GDP | 2.99% | 3.62% |
| Federal Reserve Assets 12-Month Change | +8.7% | +78.7% |
| Federal Reserve Assets / GDP | 5.5% | 34.2% |
| Real GDP, 12-Month Change | +2.34% | -2.56% |
| Annual Budget Surplus / GDP | +1.4% | -16.1% |
| Federal Government Debt / GDP | 57.7% | 127.3% |
| Baby Boomer, Age Range | 36-54 | 57-75 |
| Generation X, Age Range | 20-35 | 41-56 |
| Millennial, Age Range | 4-19 | 25-40 |

*Sources: Kitco, Barron's, Investors Intelligence, Conference Board, American Association of Individual Investors, Investment Company Institute, Charles Schwab & Co., FINRA, Federal Reserve Economic Data (FRED)*