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Those Burned in Internet Frenzy Should Have Studied Similar Bubbles in '60s and '70s : Investors in Web Can Learn From Past Errors

By Sharon Reier, International Herald Tribune

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ANYONE WHO participated in the Internet frenzy of 1999 and early 2000 and got burned in its aftermath, could have learned from history by checking out the views of Benjamin Graham, the father of value investing, who witnessed a similar bubble in initial public offerings in the late 1960s and early 1970s.

In a 1973 update of his investment classic "The Intelligent Investor," originally published in 1949, Mr. Graham concluded: "The speculative public is incorrigible. In financial terms it cannot count beyond three. It will buy anything at any price, if there seems to be some 'action' in progress. It will fall for any company identified with 'franchising,' computers, electronics, science, technology or what you have when the particular fashion is raging."

New computer stocks, according to Jay Ritter, a professor of finance at the University of Florida who specializes in IPOs, have been a mainstay of the speculative markets in 1972, 1983 and 1986 as well as recently. In fact, Mr. Ritter said, despite the IPOs of Microsoft Corp., Oracle Corp. and Sun Microsystems Inc. in 1986, "there were so many others that as a group they did badly."

Addressing the period that Mr. Graham analyzed, Mr. Ritter said there were booming IPO markets. "Then in the spring of 1973 the IPO market shut down, and from 1973 to 1979 the IPO market was dead and almost everything that went public in 1972 was a disaster. Those investors got massacred in the 1973-74 bear market."

Markets in other countries have for the most of this century been spared such manic-depressive IPO cycles, according to Mr. Ritter. Until the latest frenzy, non-American IPOs have consisted of almost entirely well-seasoned companies.

Mr. Graham illustrated his disgust for crowd psychology by spelling out the history of a franchising IPO called AAA Enterprises Inc. that dazzled the public to the extent that its stock price was bid up to a "tidy 115 times earnings." The story serves as a parable for investors' eager willingness to ignore financial signposts.

"About 15 years ago," wrote Mr. Graham, "a college student named Williams began selling mobile homes (then called trailers)." By 1965, the business sold $5.8 million worth of mobile homes and earned $61,000 before taxes.

By 1968, he joined the franchising movement and was selling others the right to sell mobile homes under his business name. "He also had the bright idea of going into the business of preparing income tax returns, using his mobile homes as offices, and formed a subsidiary called Mr. Tax of America, and of course started selling franchises to others," Mr. Graham said. By March 1969 a major stock exchange house was willing to take the company public. It offered 500,000 shares at $13 per share

Of the 500,000 shares, 300,000 were from Mr. Williams's personal account and 200,000 for the company account. That added $2.4 million to AAA's coffers. The stock price promptly doubled, to $28, meaning the company had $84 million in equity, against a book value of $4.2 million and maximum reported earnings of $690,000

As Mr. Graham saw it, this was "not a bad deal for Mr. Williams." The 300,000 shares he sold had a book value of $180,000, and therefore he netted 20 times as much or a cool $3.6 million. The underwriters and distributors split $500,000 between them, less expenses.

"This," wrote Mr. Graham dryly, "did not seem so brilliant an idea for the clients of the selling houses. There were ambitious plans for the future of course — but the public was being asked to pay heavily in advance for the hoped-for realization of those plans."

Like many Internet-related companies, AAA Enterprises used its enlarged capital to buy other businesses: a chain of carpet stores and a mobile-home factory. "The results reported for the first nine months were not exactly brilliant," remarked Mr. Graham, "22 cents per share vs. 14 cents."

But events over the ensuing months were "literally incredible," according to Mr. Graham. "The company lost $4.365 million ,or $1.49 per share. This consumed all its capital before the financing plus the entire $2.4 million received on the sale of this stock plus two thirds of the amount reported in the first nine months of 1969.

"All that was left was 8 cents per share worth of capital for the public stockholders who had paid $13 per share for the new offering just seven months before."

For the first half of 1970, the company reported a further loss of $1 million. It now had a good sized capital deficit and was kept out of bankruptcy by loans made by Mr. Williams up to $2.5 million. No further announcements were made until January 1971, when the company filed a petition for bankruptcy. "The quotation for the stock at month-end," concluded Mr. Graham, was still 50 cents a share bid, or $1.5 million for the entire issue which evidently had no more than wallpaper value."

Wallpaper value is a good way to describe many of the Internet stocks that are still trading.

Mr. Ritter commented: "The magnitude of the collapse has surprised a lot of people, although it looks like it has not bottomed out yet. There are a lot of them way down, but they still haven't gone bankrupt. Most of them will."

Echoing some of the journalists of today who are taking Internet analysts like Merrill Lynch & Co.'s Henry Blodgett and Morgan Stanley Dean Witter & Co.'s Mary Meeker to task for recommending Internet companies with more sizzle than economic prospects, Mr. Graham wrote in 1960: "Questions remain. Should not responsible investment houses be honor-bound to refrain from identifying themselves with such enterprises, nine out of 10 of which may be foredoomed to ultimate failure?"

Although Mr. Graham believed that when he entered investing in 1914, the brokerage houses had more integrity, he responded to his own question: "As we write this edition, a movement toward reform of Wall Street abuses is under way. It will be difficult to impose worthwhile change in the field of new offerings, because the abuses are so largely the result of the public's own heedlessness and greed."

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