The Internet Years Of Our Lives

Kids say and do the most interesting things; kids whose parents work at home and have a *Bloomberg* perched on their desks may say and do interesting things related to financial markets at an earlier age than most.

Back in the late 1999 surge in technology stock prices, triggered in part by the Federal Reserve's literal printing of money to forestall all of those Y2K problems predicted both by a legion of computer consultants and Alan Greenspan's imaginary friend Atlas, I showed my older son a monthly chart of Microsoft on a semilogarithmic scale going back to March 1986.

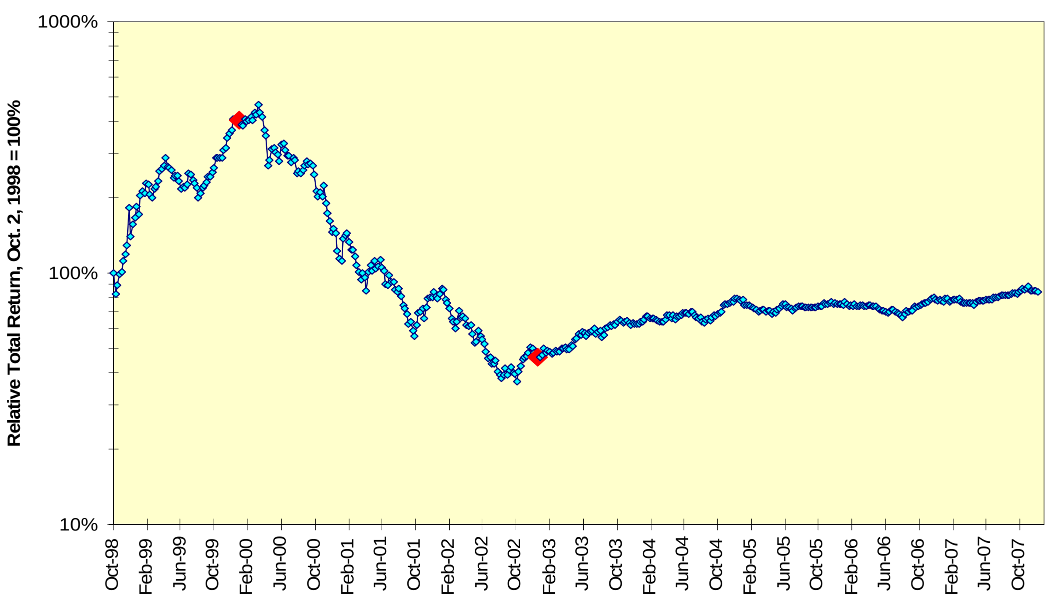
Was he impressed? No, he deflated Dad by asking, "Why didn't you buy it back then?" I thought about the question for a while and rather than admit to the obvious, "Well, because I [fouled] up," I launched into a panoramic explanation of what the personal computer software industry of 1986 looked like.

Those thoughts turned into a January 2000 column, updated and revisited in December 2002, that produced the second-most email I ever received from *RealMoney* readers (the first being a post-September 11 column on trading in airline options).

The thesis both times was simple and direct: If you are making a bet on the ultimate success of an industry but are uncertain as to which company to buy, you have to buy them all. That results in extreme apparent overvaluation for nearly all of the firms in that industry basket, but the one winning trade should pay for all of the losers. You are buying a call option on an industry, not on the singular success of an individual firm.

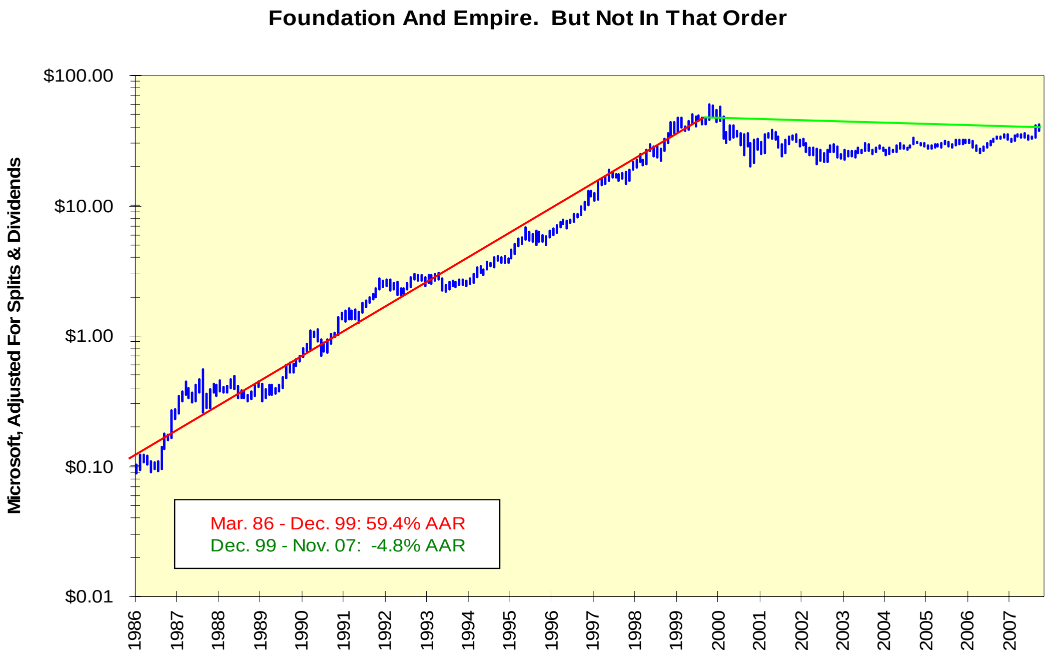
In hindsight, I unwittingly managed to bracket the peak and trough of the Internet boom and bust fairly closely. The total return of TheStreet.com's Internet index relative to that of the Russell 3000 is presented below with the dates of those two columns highlighted in red diamonds. The chart also gives an indication of the industry's post-2003 maturation after its wild boom and bust.

Relative Total Returns, TSC Internet Index Vs. Russell 3000



Revenge On The Nerd

Here is what the monthly logarithmic chart of Microsoft, pre- and post-December 1999, looks like. The average annual total return for Microsoft through December 1999 was 59.4%; it has been -4.8% since then. Dow Jones added Microsoft into the Dow Jones Industrial Average on November 1, 1999; I wonder whether any of them had to take heat from their kids on that decision.

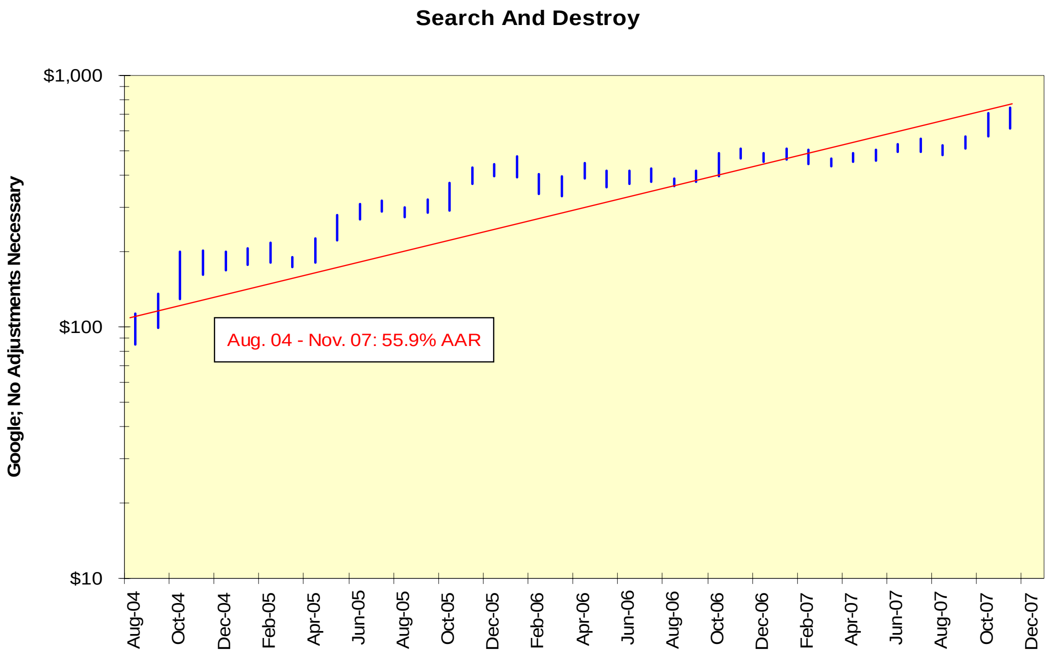


New Kid On The Block
A Chicago businessman in his late 70s asked me earlier this year whether I ever thought two of the biggest firms in the country would be named, "Google" and "Yahoo!" To ask the question is to answer it; names like that are certainly a far cry from 1920s titans like U.S. Steel and Radio Corporation of America whose businesses were clear from their names.

I happen to love Google as a user; I think Google ranks up there with fire and the wheel in the human achievement department. Now that former General Motors chairman Roger Smith died last month, I might ask Michael Moore to update his 1989 classic *Roger & Me* to be called first, *Me & Roger & Me* and then finally, *Google & Me*. The fact I can understand how I have contributed revenue to General Motors but still cannot understand how Google has ever made a penny off me is irrelevant; it is the ultimate arbiter of all disagreements between friends and spouses.

What is relevant is I twice used Yahoo! to illustrate the principle of buying a whole Internet industry. I would not think of it as the bellwether for the Internet industry today. Just as I would have bought Lotus for a spreadsheet, WordPerfect for a document creator, Novell for networking, Ashton-Tate for a database manager, etc, in 1986 only to watch Microsoft steamroll them all, I would have done the same thing with Yahoo! only to watch Google leave a footprint on its posterior.

And, oddly enough, the average annual return for Google since its August 2004 IPO, 55.9%, is strangely similar to the early success of Microsoft. This is just an observation, not a forecast.



The Google Bet

Let's update the 1999 and 2002 analyses replacing Yahoo! with Google. At the close of business on December 7, 2007, Google was selling at 46.02 times estimate 2008 earnings, which translates into an earnings-to-price ratio of 2.17%. This number can be compared to the 4.105% yield on the ten-year note, which also is an E/P ratio. The analyst consensus for Google's long-term growth rate is 35.32%, and three-year LEAP volatility is 36.39%.

The dividend discount model of a stock over a ten-year period is:

$$Stock = \sum_{i=1}^{10} \frac{Dividend_i}{(1+r-g)^{10}}$$

Where r is the ten-year note rate of 4.105% and g is the growth rate of 35.32%. At the ten-year horizon, $(1 + .0415 - .3532)^{10}$ is .02371, whose reciprocal converts to a P/E of 42.18.

If Google's earnings did in fact grow at 35.32% per annum for the next ten years, they would be 20.59 times as great at the end of 2017 as they are today. If we plug these numbers into the range bound formula below to see how many standard deviations, Z, we would have to move from the current price to get 20.59 times current earnings, we can solve for Z= 2.63.

$$Z = \frac{\ln(20.59)}{\sqrt{10} * .3639}$$

That number translates to 99.57% probability of Google staying below that ten-year growth rate; restated into odds, you have 233:1 odds of Google underperforming this price target. Given the histories of both Microsoft and Yahoo!, you might be tempted to take that bet against this growth lasting forever. Just do not bet against the Internet being a larger and more important part of your life; it will be over the next ten years just as it has over the past ten years.

Postlogue

Google a terrific company with great products, it has at least one important convert, my older son who chided me for not buying Microsoft. He now relies both on aGmail address (levisimons@gmail.com; send him a note to congratulate him on his engagement) and on Google's Web-based substitutes for Microsoft's Office suite…all to run on a Linux OS. Dad, forever a knuckle-dragging hominid from the Pleistocene, does none of the above.