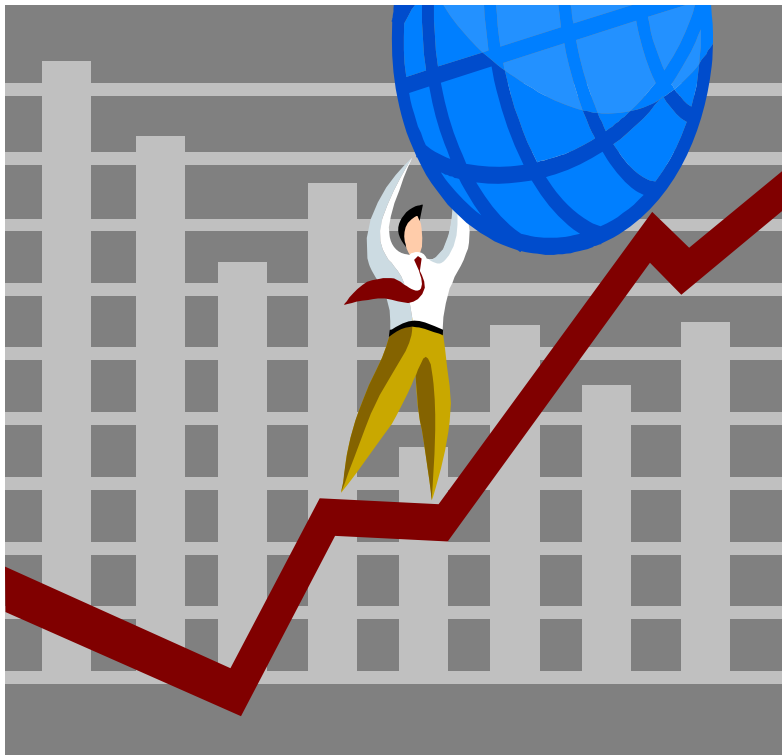


# Emperor's New Clothes

## 1994 Q4 Quarterly Commentary



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### Emperor's New Clothes

Momentum investing, long a staple in the commodity pits of Chicago, has now arrived full force in the technology and communications sectors of the world equity markets. This has led to tremendous price appreciation in those sectors over the past year and led the retail investor to "pile-on" in the past three months (historically, such piling-on has indicated the end of a sector's or asset class' out-performance).

During the past 24 months, established security analysis has been thrown out. Value companies (which can almost be defined as all companies that are not technology or communications related) are dirt cheap, many selling for less than 10 times earnings. Comparing a company to a bond with the company's earnings similar to the coupon, or interest paid on the bond, today's value companies are similar to a bond with 10% interest rate. Many technology companies, on the other hand, are selling for more than 100 times earnings, or a bond with a 1% interest rate.

Continuing the metaphor, why would an investor pay \$100 for \$1 of earnings when he can pay the same \$100 for \$10 of earnings? That is because analysts today, more than ever before, are valuing companies not on what they earn but on their capacity to grow earnings. Therefore, a company that earns \$1 but is expected to grow by 50% over a period of years is valued over a company that can earn \$10, year in and year out.

Using another analogy, that of automobiles, today's stocks are not being valued by how fast a car can go, but by how quickly a car can accelerate. The problem with this methodology is that it is heavily dependent upon predictions of the future which are inherently inaccurate, very susceptible to market psychology and most importantly, mathematically very risky. (For the more mathematically inclined, this is because many analysts are valuing stocks, not on the speed of the car, not on the car's acceleration but its ability to increase its acceleration. Mathematically, this is the second derivative of velocity and is very unstable.)

Estimating a company's value by this method yields startlingly different results with only slightly different inputs. Therefore, it should not be a surprise to anyone that Yahoo is down nearly 40%, Amazon.com down more than 40% and AOL almost cut in half, all in the past two months. We continue to look for more volatility in the markets this year.

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