

# Invest

## Where the Action Is: Everything Old is New Again

### Greetings from LFS



Dear Clients and Friends:

Here is my quarterly newsletter, *Invest*. The goal of *Invest* is to keep you abreast of what is happening in the financial market, inform you about new investments and keep you informed about your current investments.

Let me know what you think – I welcome any questions, comments or suggestions.

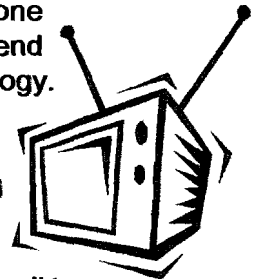
Sincerely,

Douglas Ruth

### Invest

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Currently, when talking to anyone about investing, conversations tend to start and end with technology. Technology is affecting every part of our lives including the time we spend watching television. When people discuss television, a common comment is "I feel like I've been 'dot-commed' to death during commercials."

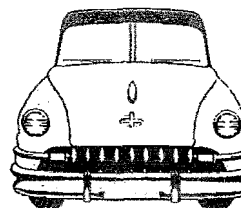


According to Anthony B. Perkins, editor-in-chief of *Red Herring* and coauthor of *The Internet Bubble*, Internet companies spent \$400 million during the first six months of 1999 on TV ads and \$90 million for radio spots. No wonder the public feels overwhelmed by this media blitz.

The revenue growth of some of the leading technology companies is impressive:

Amazon.com	
Year	Revenue
1995	\$0.5 million
1996	\$15.7 million
1997	\$147.8 million
1998	\$610.0 million
1999	\$1.5 billion*
2000	\$2.5 billion*

\*projected



Amazon.com's total projected revenue growth rate is 5,000 times their first year's sales; the equivalent of a rookie sales representative selling one car in 1995 and 5 years later, selling 5,000. That's impressive growth!

Other Internet companies have similar revenue growth stories:

<b>America Online</b>	
<b>Year</b>	<b>Revenue</b>
1991	\$21.4 million
1992	\$26.6 million
1993	\$40 million
1994	\$104.4 million
1995	\$394.3 million
1996	\$1.16 billion
1997	\$1.76 billion
1998	\$2.6 billion
1999	\$4.8 billion*
2000	\$6.7 billion*

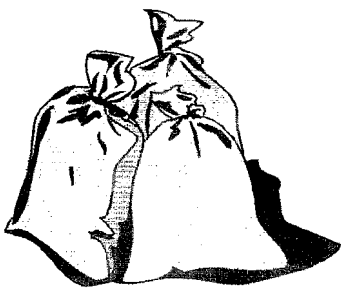
\* projected

America Online has a total projected revenue growth of over 300 times their 1991 sales.

<b>Yahoo! Inc.</b>	
<b>Year</b>	<b>Revenue</b>
1995	\$1.4 million
1996	\$19.1 million
1997	\$67.4 million
1998	\$203.3 million
1999	\$575 million*
2000	\$8.75 million*

\* projected

Yahoo! Inc. has a projected total revenue growth of over 600 times their 1995 sales.



It is easy to get caught up in the excitement. Revenue growth is "the story," it is the only thing that matters to people who encourage investors to buy technology stocks.

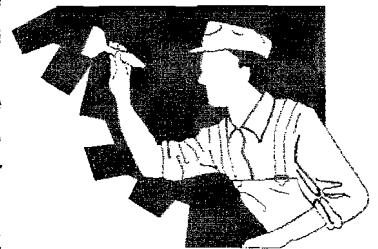
What really matters, however, is earnings. After a company sells its product or service, are there profits left over?

As Amazon.com increases sales, losses also increase.

<b>Amazon.com</b>		
<b>Year</b>	<b>Sales</b>	<b>Losses</b>
1995	\$0.5 million	\$0.3 million
1996	\$15.7 million	\$5.8 million
1997	\$147.8 million	\$27.6 million
1998	\$610.0 million	\$74.4 million
1999	\$1.5 billion*	\$435 million*
2000	\$2.5 billion*	\$455 million*

\*projected

This is the equivalent of a tradesman determining that he needs to make \$25 per hour to cover costs and then pricing the service at \$20 per hour. As the old joke goes, he will make up the \$5 per hour shortage by working longer days!



Both America Online and Yahoo! Inc. have profits. The questions that everyone would like answered are:

- Can the profit margin be maintained?
- Can the profits expand?

<b>America Online</b>		
<b>Year</b>	<b>Profit Margin</b>	<b>Profits</b>
1991	4.4%	\$ 0.9 million
1992	8.3%	\$ 2.2 million
1993	7.7%	\$ 3.1 million
1994	5.9%	\$ 6.2 million
1995	4.8%	\$ 18.9 million
1996	2.7%	\$ 29.8 million
1997	0	(\$ 71.5 million)**
1998	5.1%	\$132.6 million
1999	10.2%*	\$486.0 million*
2000	14.5%*	\$960.0 million*

\* projected

\*\* loss

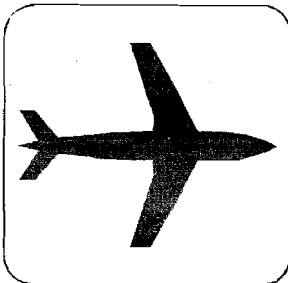
Yahoo! Inc.		
Year	Profit Margin	Profits
1995	Negative	(\$0.6 million)**
1996	Negative	(\$2.3 million)**
1997	3.3%	\$ 2.2 million
1998	24.6%	\$49.9 million
1999	18.3%	\$105 million*
2000	20.0%	\$175 million*

\* projected

\*\* loss

The profit growth of both America Online and Yahoo! Inc. is impressive but is it sustainable? The success of both these companies has attracted competition. Will these competitors take market share and profits from either of these companies?

Some people suggest that the most important part of the 20<sup>th</sup> century was the continuous development of technology. While people are focusing on the technology stocks of the moment such as the Internet, telephone and computers, an established track record shows how previous technology companies have performed.



The classic example is the airline industry. Many of us take flying as a very routine part of our jobs or lifestyles. It is interesting to note that the airline industry is only about 60 years old.

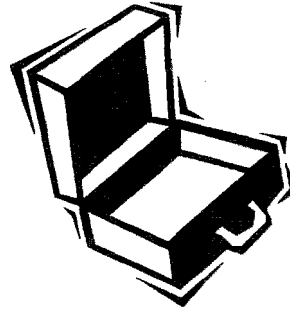
On December 5, 1999 an ad ran in the *Chicago Tribune* Travel section that showed a one-way airfare of \$93 from Chicago O'Hare to Los Angeles. The airline, America West, uses a Boeing 767 which seats 206 people. If the flight was full and everyone paid the same fare, one trip would generate revenues of over \$19,000.

$$\$93 \times 206 \text{ people} = \$19,156.$$

If someone started a new airline and only flew two flights per day (round trip from Chicago O'Hare to Los Angeles and back), 5 days per week, 50 weeks per year, tremendous amounts of revenue would be generated:

$$\$19,156/\text{flight} \times 2 \text{ flights/day} \times 50 \text{ weeks} \\ \times 5 \text{ days/week} = \$9,578,000$$

Airline sales are measured in billions of dollars. Most consumers are interested in getting from Point A to Point B for the least amount of money. Getting to the destination is much more important than the airline on which they fly.



A traveler might fly on the new airline 10 times and then a competitor like Southwest Airlines will offer a deal to fly to the same destination for \$75. Customers will then shift their business to Southwest. The only thing the new airline can do is to lower their

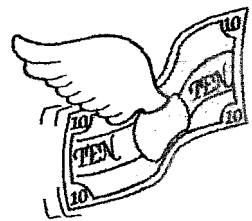
price below Southwest's to regain the business.

This strategy of constantly changing prices tends to cause erratic profits and profit margins, and stock prices. It also explains why airlines go out of business.

Even though sales are often increasing, wide swings occur in profits:

United Airlines (UAL)			
Year	Sales (\$millions)	Net Profit (\$millions)	Net Profit Margins
89	9,763.6	324.2	3.3%
90	11,037.0	94.5	0.9%
91	11,663.0	(331.9)	0
92	12,890.0	(417.2)	0
93	14,511.0	(31.0)	0
94	13,950.0	77.0	0.6%
95	14,943.0	378.0	2.5%
96	16,362.0	600.0	3.7%
97	17,378.0	728.0	4.2%
98	17,561.0	821.0	4.7%
99	17,850.0	765.0	4.3%

The critics of Internet investing believe that the same problems that challenged the airline industry will ultimately affect Internet stocks. It is sobering to realize that over 100 airlines have gone bankrupt in the last 20 years.



Understanding and interpreting are a large part of being a successful investor. Bill Miller, the portfolio manager for the Legg Mason Value Trust has been one of the best in interpreting information. Mr. Miller is the number one fund manager of the 1990's and his fund has out-performed the market in nine out of ten years.

Mr. Miller is a traditional value investor. Usually, this means that he would not buy technology stocks. He, however, has been buying technology stocks and has been very successful at it.

In the November 15, 1999 edition of *Barron's*, he wrote a rather eloquent article explaining his strategies. He makes some compelling arguments on why people should invest in technology companies. Shown below are quotes which describe his strategies.

#### **Bill Miller's Investment Strategies:**

- "Although technology changes reasonably rapidly, it doesn't follow that such change is random or unpredictable. In many cases it follows well-defined paths."
- "It is true that some of the best technology companies have rarely looked attractive using tradition valuation methods, but that speaks more to the weakness of those methods than the fundamental risk-reward relationships of those businesses."
- "Microsoft has gone up about 1% per week, on average, since it has been public. Companies don't outperform year in and year out unless they were undervalued to begin with."

The Gross Domestic Product (GDP) is a domestic tool economists use to measure the total production of goods and services generated by Americans. Mr. Miller has this to say about the GDP:

- "A recent GDP figure reportedly was \$8.3 trillion. The value of the publicly traded Internet securities was just over \$500 billion or about 6% of the production of Americans."

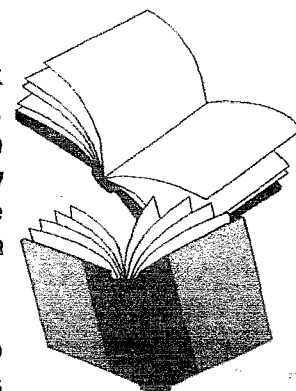
- "It seems reasonable that if the Internet really does change everything, as its enthusiasts assert, the investment opportunity is probably greater than a single digit percent of GDP."
- "The market believes it knows where a lot of opportunities are: the combined market value of AOL, Yahoo! Inc. and Amazon.com is about 40% of the total value of all Internet stocks."

#### **A Brief Review of the "Big Three:"**

**Amazon.com** started in July 1995. The company is now one of the world's largest booksellers.

The company allows a customer to do anything possible that can be done with a book, including:

- Buying a book.
- Searching for a book in a number of ways. Finding a book when you do not know exactly what you are looking for can be a challenge.
- Allowing customers to read reviews of books and post their own reviews.
- Running promotions and allowing customers to check their order status via computer.



The book business is a mediocre one at best. There are relatively small profit margins and a lot of waste. Many books end up on the discount table.

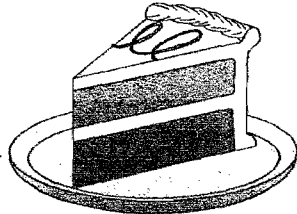
Amazon.com continues to evolve and also sells CDS, videotapes, toys, electronics and even hardware. The company also has a 46% equity investment in Drugstore.com and a 50% equity investment in Pets.com.

Customer accounts continue to grow. According to the *Valueline Investment Survey* in September 1999, the company had 13.1 million accounts versus 10.7 million at the end of the June quarter with 72% of orders from repeat customers.

Yahoo! Inc. was developed in 1994 by David Filo and Jerry Yang while they were attending graduate school at Stanford University. The company began in 1995 and completed an initial public offering in April 1996.

The concept of Yahoo! Inc. is that it allows a customer to search the Internet and find information on any subject matter, similar to a card catalog in a library or an index in the back of a book.

A simple example would be a person who is interested in making a chocolate cake. We would get out the *Betty Crocker Cookbook* and look in the index which would refer us to a recipe on a certain page.



We could also go to the library and use the card catalog. We could find information about cakes by subject by looking up "cookbooks" or searching by an author's name such as "Julia Childs."

These methods were effective for decades and still work just as well today; however, the new and improved method for securing information is to turn on a computer and key "chocolate cake."

My son Sam and I did just that and what appeared was the following:

- 23 subcategories;
- 553 sites (referred to as "hits");
- References to countless articles; and
- 5 ads for various products and services.

Yahoo's! product is the "card catalog" which allows users to find out everything there is to know about chocolate cakes or any other subject. Some of the ads Sam and I saw were from other food companies such as Fancy Food Gourmet Club and Candybarrel.com. People who are interested in cakes are probably interested in other sweets as well.

There was also an ad for Barnes and Noble. Maybe they feel we are candidates to buy a cookbook. Yahoo! makes money by charging vendors to place their ads in the company catalog.

A cook making a cake is only interested in finding out about baking. They probably do not care which card catalog they use. Currently, there are other alternatives to using Yahoo's! services; other Internet providers also supply similar card catalogs.

It is difficult to know what the future will bring as to who will provide these services and how many services will be available.

America Online (AOL) started in 1985. The company was listed on the NASDAQ in March 1992. The company has over 21 million customers who each pay \$21.95 per month for unlimited use.

$$\begin{aligned} & \$21.95 \times 12 \text{ months/year} \times 21 \text{ million customers} \\ & = \$5.56 \text{ billion.} \end{aligned}$$

Monthly subscribers represent about two-thirds of the company's revenue.

AOL customers are typically interested in:

- using e-mail.
- having access to the Internet.



There are other companies who provide these services. They would like to have some of AOL's 21 million customers. Perhaps the easiest way to get them is to offer similar services for less money.

You can see how these companies parallel the airline industry and how their performance over time could also parallel that of the airline industry.

**Valuation of Technology Stocks:** On December 3, 1999, Amazon.com was trading at \$82 per share. Bill Miller, the number one fund manager we quoted earlier, asks two questions:

1. Does \$82 overstate or understate the value of Amazon.com?
2. How can we tell if our answer is right or wrong?

Value investors would say that because they cannot answer these questions, they would not invest in Amazon.com.

Mr. Miller adopted the work of William James, who authored an essay, *The Will to Believe*. The essence of Mr. James' essay is "...that in many cases one was justified in believing something well in advance of what others may consider sufficient evidence. The evidence one demands is a function of how important it is not to be wrong." To a certain degree, this is what games of skill and/or chance are based upon. The payoff is high but the cost to "play" is relatively small.

Many people will spend a dollar on a lottery ticket. For most people, losing a dollar will not affect their lives one way or another. This also explains why lottery ticket sales go up when lottery pots get bigger. Most people, however, will not risk the family's grocery money to buy lottery tickets.

As of August 31, 1999, Mr. Miller was managing \$11.6 billion in assets. Currently, he has about 11% or about \$1.3 billion invested in Internet stocks, which is the most he is willing to lose. He believes, the payoff for being right is high (and warrants the risk).

**Product Life Cycle and Key Relationships:** It helps to review the typical product life cycle. In the late 1970's, cellular phones started to appear. The cost to both buy and use one was relatively expensive. If two people were in exactly the same business, it could be suggested that the one with the cellular phone might have an advantage over the other who did not. The "winners" in this situation are the company that:

- made the phone (manufacturer) including employees and stockholders of the company
- sells the air time (phone company) and the employees and stockholders of the company; and
- purchased the cell phone.

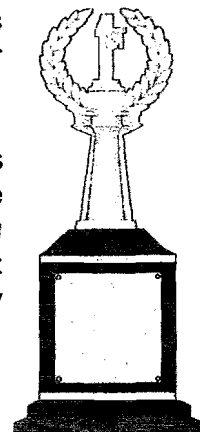
The "loser" in this situation is the business person who does not have a cell phone.



As we moved into the mid-1980's, the cost of owning a cell phone dropped significantly. It became much more affordable and many people could justify owning one.

The "winners" in the mid-1980's were the companies, their employees and stockholders that:

- made the phones: At this point in the life cycle, the companies were making less money per phone but they sold as many as they could make.
- sold the air time.



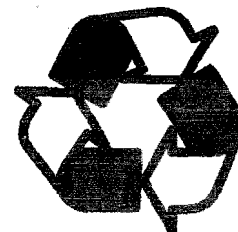
Some business people were "winners" and some were "losers." The winners were those who could use a cell phone and now became more productive. The losers were those business people who lost their competitive advantage when everyone else started using the same technology they had.

As we moved into the mid-1990's, it is fair to suggest that the power shifted significantly. Now, the winner was the consumer. The losers were

- The manufacturers, their employees and stock holders.
- The phone companies, their employees and stockholders.

If you are a phone manufacturer or a company selling air time, the only way to sell your product was to lower the price. When prices are lower, sales often go up but profits go down.

Ultimately, to be successful an investor must understand the product life cycle and a company's position within it.



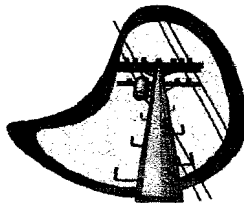
**Recommendation:** I specifically recommend that investors consider First Hand Technology Value Fund and the Legg Mason Value Trust which are described below.

**First Hand Technology Value Fund** is the number one equity fund over the past five years. Ten thousand dollars invested in 1994 grew to be worth nearly \$93,000 today. The fund has risen 52.6% annually.

The fund manager, Kevin Landis, has a Bachelor's Degree from Berkeley and an MBA from Santa Clara University. According to *Fortune* magazine, he worked as a market researcher for the firm, Dataquest, analyzing the semi-conductor sector.

Mr. Landis was working full-time for Dataquest and was involved in an investment club in the evening. He knew it was time to change careers when he was making more money from his hobby than he was earning as a full-time market researcher. He has successfully invested in the hot trends:

- **Wireless communication:** It has been suggested that in the future, telephone wires will be obsolete. Telephones will receive their power from satellites that are circling the earth. The wireless communication industry, perhaps, has the most potential in improving communication in third world countries. Wireless offers the ability to improve communication for the least amount of money in the shortest amount of time.
- **DVD:** This is essentially a new and improved way to watch a video. People "rave" about the action and sound being more realistic than the standard VHS tape.



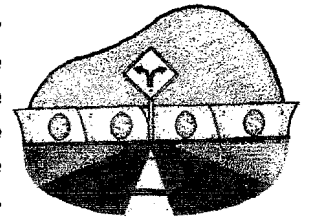
Additionally, Mr. Landis has successfully bought and sold various Internet stocks. His strategy is to focus on companies that help more traditional companies become web-savvy. He says, "I don't want to buy FTD or 1-800-Flowers but I want to

figure out who is helping them build infrastructure" and invest in them. (Emphasis added.)

**Legg Mason Value Trust:** The majority of the Legg Mason Value Trust is invested in traditional value stocks. Currently, a large portion is in banks and related financial investments. This includes companies such as Chase Manhattan, Citigroup and Bank One. Recently, other companies such as Waste Management, General Motors and Toys 'R' Us have been added to the fund.

Because of Bill Miller's success rate as portfolio manager, this fund is one investors should consider.

**Conclusion:** The purpose of this newsletter was to try to present a balanced perspective on technology investing. I believe technology is going to be the topic of choice in the year 2000. I also believe that there will be wild swings both up and down. I think conservative investors should limit technology to a relatively small portion of their portfolios. Using other strategies, such as dollar cost averaging or buying on market weakness, have historically proven to be an excellent way to invest.



**Compu-toon**



"It's amazing how loyal you are to your first phone company."