

Investing Like It's 1999: LinkedIn, Facebook and the New Growth Stock Era

Last week the initial public offering for the stock of LinkedIn took place. On the first day of trading the shares soared from their initial price of \$45 to \$122, closing at \$93 for a greater than 100 percent gain. Not since the offering of Netscape in 1995 has the market witnessed such appreciation in a single day. As Netscape set off what was known as the dot-com era, the obvious question is whether LinkedIn will do the same.

In terms of valuation the parallels are striking. LinkedIn is valued at 35 times revenues and 550 times earnings. Similar stocks such as Amazon, Red Hat and Citrix all sport P/E multiples of over 80. By contrast the overall market has a P/E ratio of about 17.

The investing public has seen this movie before and is steering clear for the most part. Most individual investors are still investing for income, given the low returns on cash and the experiences of the 2001 and 2008-9 downturns.

Among hedge funds the atmosphere is far different. As most hedge funds are paid for relative outperformance, a vehicle that can add several points to a portfolio's return is most welcome. Since the typical hedge fund manager is confident (overconfident?) enough to believe he/she can get out of an investment before it heads south, the valuation issue is of scant importance. The momentum of the investment counts for more than what it represents.

The performance of LinkedIn has a rich history. Companies that represent new concepts that cannot be easily compared to an existing public company tend to be treated as "new era" investments. Such investments are free of comparisons with either peers or reality. Since LinkedIn and other social networking sites lack comparative models, who is to say what their growth rate will be, or how long it will last? This was the same rationale that drove the Internet stocks of the late 1990s to absurd heights. Since the companies had no earnings they were evaluated based on the number of "clicks" per share. Never mind a click was not the same thing as a profit. When the music stopped many of the stocks were crushed and an equal number of investors felt like they had been following the Pied Piper.

Can LinkedIn usher in a similar era? Not on the same scale. The experience of public investors is too recent to succumb to such blandishments a second time in just over a decade. While there will always be people who will be fascinated with the new, there are probably not enough of them to keep the rally in technology going.

A case in point is the performance of the “old” technology stocks. Companies like Hewlett-Packard, Cisco, IBM and the like have P/E ratios that are not only below the “new wave” favorites, they are also below the overall market. The common thread of “old” technology companies is that they deal in tangible goods to various degrees; computers, routers and the like. Some of these firms have diversified into services with varying levels of success. Typically consulting services have lower profit margins than manufacturing, requiring more revenue to attain the same amount of profit.

The decline in profit growth of the former technology leaders stems from what I have described earlier as the Faustian bargain of technology: technology revenues grow because prices are cut for the product. So long as unit growth outpaces the price reductions revenues go up. When price cuts outweigh unit demand growth revenues and profits fall.

Like its Internet predecessors, LinkedIn does not make anything. Instead it has over 100 million members (45 percent in the US and 55 percent elsewhere) and is a Facebook of sorts for professionals. It makes money selling online advertising and seeks to become an employment service for its members.

The problem is that these functions are not proprietary. Monster Worldwide is a service that already provides employment online. Facebook could start a separate site for professionals if it wanted. While Facebook is not yet a public company, Monster sells for a P/E of 20. Compared to LinkedIn this would be considered a bargain. And lest we forget Myspace, which came and went in a flash, there is really nothing to prevent other websites, including LinkedIn, from doing the same.

CNBC commentator Larry Kudlow praised the performance of LinkedIn last Friday, saying that it proves the return of “animal spirits” to Wall Street. Last time animal spirits were upon us most investors got mauled. Caveat Emptor.

The Economy

Most indexes of economic activity are showing moderating growth. While housing continues to drag on the economy, manufacturing and exports have been doing well. Government spending is also a negative as the Federal stimulus program winds down and states continue to cut back due to their own budget issues.

Looking ahead, one factor that is overlooked is the economic activity that will be required to restore various areas impacted by recent flooding, tornados, and other natural disasters. Part of the cost will be borne by the Government and part by insurance companies, with the balance coming from the victims themselves. While one would never wish such catastrophes on anyone, their economic consequence is to promote rebuilding which will have positive benefits for the housing and construction industries. For these reasons we see economic activity picking up as the second half progresses.

Interest Rates

The Federal Government continues to be the borrower of first resort. The growth of Federal debt is not offsetting the decline in consumer debt. Corporations have shown a propensity to borrow, mainly to either buy back stock or in expectation of higher interest rates in the future. One railroad, Norfolk Southern, issued bonds with a 100-year maturity.

The reduction of the Government purchases of bonds will be gradually undone starting in July. This act is supposed to nudge interest rates upward. It will also help to reduce the deficit since the proceeds will be considered receipts.

As for extending the ceiling on the amount the Government can borrow: it is considered to be a certainty once each side of the political aisle has had a chance to posture on its own behalf. After the problems encountered by the Republicans on the issue of reducing Medicare and Social Security, it is a given that some creative way will be found to finesse the situation. The Republicans are caught between their largest contributors who do not want a tax increase even at the expense of cutting social programs, and their members who have signaled that they will tolerate some tax increase to preserve the same. Since the Republican leadership is on record objecting to any tax increase, the only way to keep benefits going is to raise the debt ceiling. Expect this to be a contentious issue in 2012.

Inflation

Inflation is about to get a push from China. After years of providing ever cheaper goods, Chinese exports of apparel and other goods are slated to increase ten percent this fall. While clothing makes up a small part of total consumer purchases, it is an omen of things to come.

China has historically produced for export. As domestic demand becomes more robust, expect Chinese buying to be a factor in other areas such as food prices and labor. The latter will be the result of firms deciding that outsourcing to China is not the panacea that it is cracked up to be. The return of manufacturing jobs from China is expected to be a key factor for domestic employment in 2012 and beyond.

The Stock Market

Stocks have been in a range-bound pattern since the end of the first quarter. Given the orderly nature of the decline, it is expected that any setback at this point is temporary until the economic momentum is restored in the second half.

Within the universe of stocks, foreign mutual funds seem to continue to struggle with an ongoing decline in the dollar. Exporters of course benefit from the same. With the exception of retail as a group and other consumer industries, the market seems to be progressing rather well.

Warren M. Barnett, CFA
May 24, 2011

© 2011 Barnett & Company