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## Ariadne's Thread and the Amazons

Theseus is a hero of Greek mythology, famous for slaying the Minotaur. King Minos of Crete demanded of Athens an annual sacrifice of 14 youths to feed the Minotaur. The monster lived in a labyrinth, where the sacrificial victims (or anyone else venturing in) would be hopelessly lost until they became dinner. Having decided to end the annual sacrifice of his fellow Athenians, Theseus was helped by Ariadne, the daughter of King Minos, who gave Theseus a ball of thread. He tied one end of the thread to a stone at the entrance of the labyrinth and, after killing the Minotaur, found his way out by following the thread. As you may recall, Tom Sawyer had the same idea in the cave.

Among his other varied achievements, Theseus defended Athens from an invasion of the Amazons. These warrior women didn't fare well in Greek mythology -- in another story, they also had to fight (and were defeated by) Hercules. (If you think Theseus had some tough jobs, think of the teacher trying to convince a room full of prep school boys that an invasion by women is a bad thing.)

***Like classical Athens, we recently suffered an invasion by Amazons. As if in a myth, investors were transformed into speculators.***

While modern times may lack the drama of Greek mythology, we see some parallels between the financial markets and the adventures of Theseus. We were recently invaded by Amazons, the dot.com companies that stirred imaginations and, in myth-like fashion, transformed investors into speculators. Lest you think we are picking on Amazon as a result of its recent difficulties, we pointed out the mythological quality of placing a value on Amazon (then at a split-adjusted price of \$64 per share) greater than the entire stock market of Norway in February 1999. We marveled at the price/sales valuation of Amazon (at \$64) and other Internet companies in January 2000. We compared Amazon (at \$36) to the South Sea Bubble last June. As this is written, Amazon stock is below \$13.

When Amazon announced disappointing results the other day, we heard an analyst on CNBC doubting that they would ever make money, given their transparently low margins on the books and other items they sell. But weren't those margins just as low and just as transparent when the stock was selling well above \$100 per share in late 1999? How could so many investors have gotten lost in the labyrinth of Internet and tech stock hype?

The first thing to realize is that a great company and a great stock are not one and the same. Your investment returns will suffer if you pay too much for the stock of a company, even if it's in a wonderful business. This is our criticism of much of what passes for "advice" on how to invest -- e.g. go to the mall and

watch what kind of frozen yogurt the shoppers like. That might tell you what kind of yogurt you should order, but it does little to tell you how much the yogurt company's stock is worth.

In this sense, it is unfair for us to focus on Amazon's stock (other than the nifty mythology tie-in) since we are loyal customers and we patronize few other Internet retailers. Yes, we check the books we want to purchase on another web site that compares the prices of various booksellers for a given title, but if the price is close, we choose Amazon, given the speed and packaging of their shipping. Of course, if you tell us of an auto insurer that is willing to lose money on its insurance underwriting, we'll probably be loyal customers of them, too. We love Amazon because it is willing to sell us books at a loss, the same reason we do not like it's stock.

***Valuation is the Ariadne's thread of investing, a logical approach when facing uncertainty.***

No, the problem of the Internet and other technology stocks that led the bubble of 1999 and early 2000 was that speculators threw money at the stocks without much if any consideration given to the intrinsic value of the companies, based upon their fundamentals and earnings power. This is not a problem limited only to high-flying tech stocks, although the risks may be more obvious there. It was also not an error committed exclusively by novice investors, since many professional investment managers were among the most full-throated members of the chorus singing the praises of tech stocks.

Humans tend to be overconfident of their expectations of the future. Like entering the labyrinth, any stock market investment entails risk. The problem is that if we allow ourselves to get caught up in the "story" and emotions of an investment and the fantasy of everything going perfectly, we have no way out if things do not go as planned. Valuation is the Ariadne's thread of investing, a discipline to fall back upon when you get lost, a logical approach when facing uncertainty.

Focusing on business valuation has a problem, though -- it's hard work and, unless you are somewhat atypical, boring. Faced with a choice of the tedious work of valuing businesses or getting caught up in the romance of the new new thing, many professional and novice investors choose the latter. It is not as if focusing on the fundamentals is a secret -- it just doesn't capture the imagination of people who would rather be doing something else.

The Minotaur was half man, half bull, a fair description of speculators a year ago, many of whom have since been slain. If you would like an investment program based on a rational, disciplined approach, not on the investing myths heard from your brother-in-law or while standing in line at Starbucks, contact us.