
Ricercar Fund /SA

“*The Paradox of Perfection*”

RELEXIVITY IN INTERNET STOCKS

THESIS BY: SHAWN ANDREW

PROJECT: TRADING FORMULATED HYPOTHESIS

SECTOR: INTERNET

METHODOLOGY: DOW JONES INTERNET E-COMMERCE INDEX
DOW JONES INTERNET SERVICES INDEX
AMEX GENERAL INTERNET INDEX IIX

INTRODUCTION

To paraphrase Robert M. Smiley, the greatest delusion could be the perceived hypothesis I am about to describe is a delusion or mirage that does not exist. Whether the latter is the case or not, only time will tell

This article is not intended to explain the Theory of reflexivity. There are books and articles that do a far better job of explaining it. The “*Alchemy of Finance*” by the founder of the theory himself is a perfect example. My purpose of writing this Article is to expose a sector today where reflexivity is occurring. With that said nevertheless, a brief description of what reflexivity is seems fitting.

The paradigm, “The general accepted prevailing theory of a problem” has no impact on the nature of the universe. Whether the prevailing theory states that the sun rotates around the Earth, or that on the contrary, the earth rotates around the Sun has no effect on the sun or the earth. The statement and the content of what the statement carries are totally separate. In other words there is a criterion of separation of object and subject.

In the social discipline especially decisions of people and human institutions, it is subject to continuous change. You can never have an independent separation of the paradigm and the contents of what the paradigm is about. What happens in most cases is once the statement is made, it influences the contents of the statement itself, and in some cases the contents of the statement end up changing so as to validate the statement however wrong it originally was. What one ends with is a self re-enforcing process, a moment of truth, twilight period and eventually self defeating process.

THE CONCEPT:

The origins of Internet search engines stems from a simple tool of aiding users find what they are looking for. They succeeded the famous Unix "Archie" program. To understand the way search engines operate let us make an analogy with a Unix (UFS) file system.

If one was looking for files containing the word "delusion" on his or her UFS system (Unix File System) they would issue a command such as:

"find - name -print | egrep delusion." The "find" command is the search tool that generates the lists and locations of all the files on the persons UFS system. The "egrep" tool is a filter that grabs only the desired files. The geniality of all this is the simplicity and ease with which it can be accomplished. With web-tools being developed each day it's becoming much easier to implement such applications.

What would it take to create a search engine? Little! The ease with which search engines can be made is vividly seen in their numbers. As of this writing there are over 400 search engines.

ANALYTICAL APPROACH:

The idea was sold to Wallstreet as such. The search Engines were able to attract users to portal sites. This increases web traffic and naturally hits. Having more traffic hits of users meant they would sell services, advertisements and generate earnings. Huge earnings!

Like most ideas the concept appeared sound, but had to be put to the test. As people increased the use of the search engines Wallstreet was left with the never-ending dilemma of how to value these engines and predict future earnings. Eager as always to jump on the bandwagon least somebody gets on before them, they never waited to validate their hypotheses. To them the phrases "hits" and "earnings" were tautological. They based their thinking on the more hits a Web engine had, the more money that company would generate. They took the paradigm as true for all times. Forget the earnings, they will come later.

It did not take long for the owners of search engines to catch on to this judgmental flaw. The more users they had, the more Wallstreet valued their company and rewarded their stock value. Why, the engine's task changed from trying to make money and became a business of generating hits. Services such as free email, free hosting, free chatting, etc. popped up. They scrambled like crazy for traffic so they would present the whopping bill to Wallstreet investors, who Internet philanthropically inclined, would gladly pay.

Once the prevailing bias is able to influence the fundamentals a self re-enforcing cycle insured. Who ever dared to short these stocks wound up having their bleached bones thrown in the canyons of Wallstreet. Infoseek (seek) a fairly unknown company sold more than 3com (A company that had purchased Digital Computers which I might add own Altavista, a search engine a hundred fold better than Infoseek or Yahoo).

With inflated paper the Internet companies started merger mania with their stock as the currency medium. Infoseek hurried up and purchased a virtually unknown company with its stock. Disney in the same year realizing it needed something to prevent its slide

purchased a huge share in Infoseek to become recognized as an Internet company. Alas it forgot that philanthropic Wallstreet doesn't like to be confused about the kind of business you are in. Infoseek trades much higher than Disney today.

Well not only was the prevailing bias so strong, Wallstreet even started disregarding hits and anticipating, the anticipated. A Company that had a real store and had not been able to generate positive earnings in years K-TEL declared they were tired of the real store and were going to sell their merchandise on the Internet. Wallstreet responded to this the way Indians respond to wild fire. This company KTEL had turned its problems around just like that. It was a cinch to buy it If you thought Ogden back in the 70's which generated the bulk of its earnings from scrap metal and traded at 20 times earnings was a fluke think again What multiple do you give to companies that do not even have earnings!

The bull Market was reaching its zenith. And like all Markets the third phase is when people buy stocks on hopes and expectations at inflated prices. Well as soon as reality checks in and the flaw is discovered, we run into a self-defeating process. The hopes and expectations upon which people bought these stocks vanishes like magic. When the first phase of selling came, these Internet stocks were slashed in almost half but unlike the bank stocks, Airlines etc, they quickly rallied back and some have made new highs. The last testing period must have been the August – October debacle. Having survived that test period, French curves developed. It is the same story, the Public seeing a stock which traded as high as 140, down to 70, considers it a cinch to buy it. They consider it now more an investment than speculation.

CONCLUSION

So far the experimental results are true to the theory. Having survived the last testing phase, the next phase is the twilight zone or moment of truth. We do not yet see signs of Internet search engines going burst and most of them keep rising from the new benign environment created by Interest rate cuts. Only technical analysis can predict the next phase. ***The turning point.*** I am willing to bet. Having known the flaw all along I would sit tight with long positions, however when the flaw becomes an accepted Axiom its time to exist. The question then I am left with is, when does this last phase end. Elliot wave, Speed lines, RSI Speed lines etc will tell the tale.

October 8th 1998, Shawn Andrew

Update 22nd July 1999

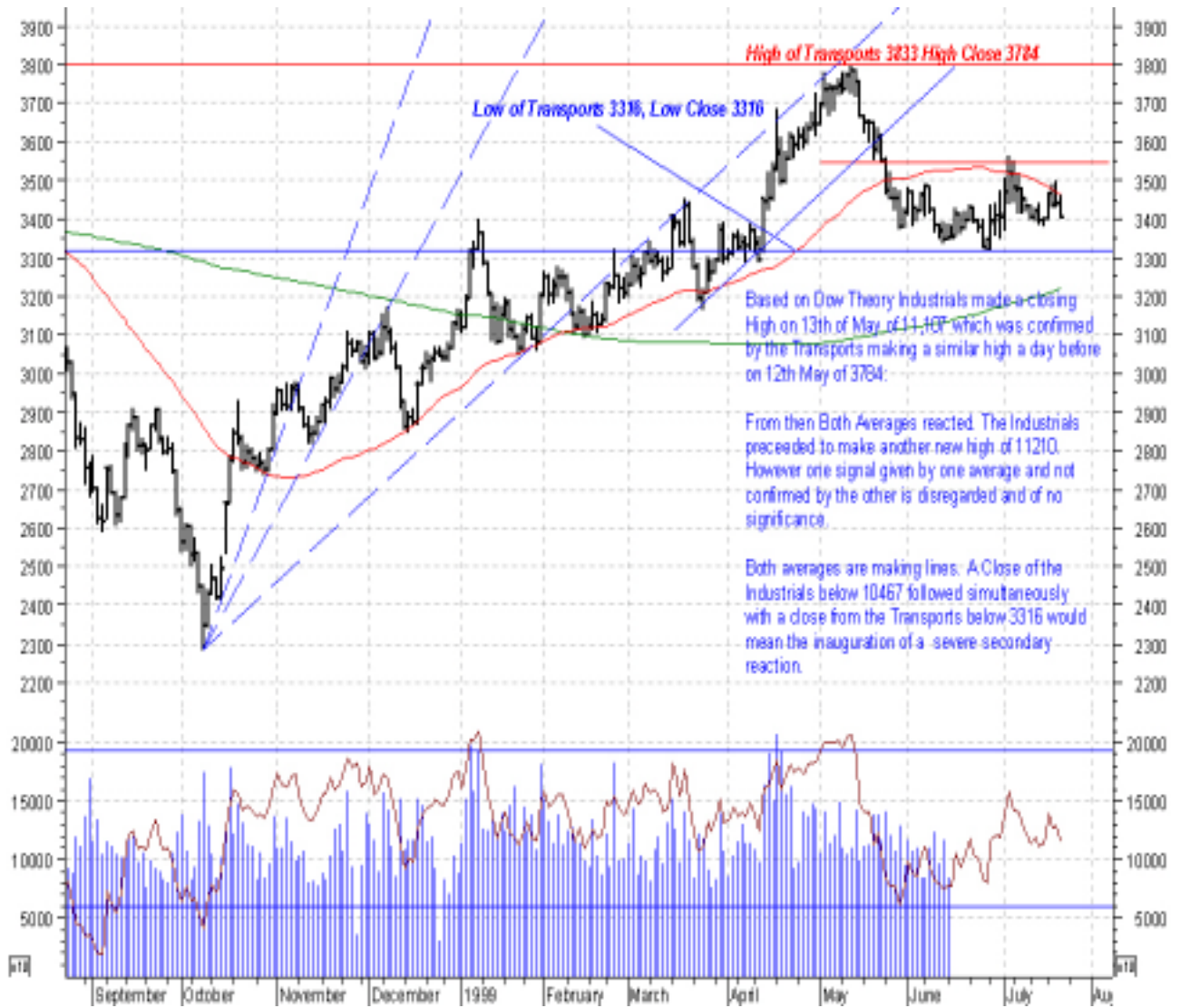
Attached:

Dow Industrials
Dow Transports
IIX Amex Traded Index Chart

DOW INDUSTRIALS (Metastock Charts)



DOW TRANSPORTATION INDEX (Metastock Charts)



INTERNET IIX AMEX CHART

