

Think your stocks have been volatile lately? Imagine

being in Tammy DiCaprio's shoes. With three children age 11 and under, DiCaprio doesn't have much money to spare. What she does have, she plows into stocks-but not just any stocks. "I only invest in Internet stocks," says DiCaprio. "I'm a big believer in the future of the Internet stocks-their potential is unlimited." An investor only since October of last year, the Chesapeake, Va., woman bought [iAOL](#), [Amazon.com](#), Lycos and [iYahoo!](#) She sold all three at handsome profits, paid a few bills, and put the remainder of the money into [iAmerica Online](#) and GeoCities, which are now her only stock holdings.

[iAOL](#) rocketed from \$64, the price at which DiCaprio started buying it in March, to a peak of \$141 in July. Then, even faster than it had soared, [iAOL](#) plunged to \$85 in September. GeoCities did even worse: DiCaprio bought it at \$38 in mid August, and after rising to \$51, it plummeted to \$21.

While DiCaprio and her husband, Phillip, both 34, have some money in diversified stock funds, Internet stocks (primarily [iAOL](#)) represent threefourths of their investments. "This is all the money that I have except what we need for our basic living expenses," says Tammy. "We really need it. I can't lose it, because that would be a big hit for us." Phillip is a Navy petty officer, while Tammy works from home for [iAOL](#). "Everything I've always heard is, invest in what you know," she says, "and what I know is the Internet."

Before the unnerving plunge last summer, DiCaprio said of her Internet investing: "This has been fun for me, but I get real nervous because I haven't been on the losing end of a stock purchase, and I know I will be eventually."

Eventually came sooner than she expected. By mid September she said she was "thinking of selling GeoCities if it gets a bounce. I'm surprised at how much it lost." But while admitting to some panic, DiCaprio remains bullish on [iAOL](#). "If I had more money, I'd probably buy more [iAOL](#) right now because I don't think it'll be this cheap for a long time."

While her single-minded devotion to Internet stocks is unusual, DiCaprio is far from alone in seeing a huge potential in Internet stocks-especially because they're down so far from their highs. The average Internet stock fell 43% from the July 6 peak through August 31. Even with the sharp decline, most Internet investors have been richly rewarded-so far. But the fact remains that most of these stocks as of mid September remained absurdly overvalued by any commonsense measure.

The real upward move in Internet stocks began toward the end of 1997 and the start of 1998. In fact, an index of Internet stocks compiled by Hambrecht & Quist is up 85% this year through September 8, even after the summer's hammering. Despite a flurry of initial public offerings, only about 40 publicly traded companies make the bulk of their revenues from the Internet-a supply-demand imbalance that has been a boon to Internetstock prices.

But even with the dramatic sell-off, substantial doubts exist about the prices of many Internet stocks. Either their earnings are nonexistent or the stocks trade at stratospheric multiples of earnings. For example, [iAOL](#) trades at 83 times projected 1999 earnings per share of \$1.23, according to First Call. [iYahoo!](#) trades at 203 times 1999 estimated earnings, or 66 times 1998 revenues. By contrast, stocks on Standard & Poor's 500-stock index sell at an average of 21 times estimated 1999 earnings.

Seeking ways to value stocks that have no earnings, Internet analysts have taken to ranking them based on their revenues per share-or on the number of customers they have, or even on the number of visits from computer users to their Web sites. But no matter how you look at these stocks, their prices still appear unrealistically high. Whereas the average stock in Standard & Poor's industrial index sells for 1.7 times sales, online bookstore [iAmazon.com](#), which doesn't expect to turn a profit until 2001, goes for 12 times sales. Similarly, search engines Infoseek, Excite and Lycos sell at 12, 15, and

17 times revenues, respectively. The prices are so high that many experts have called the Internet-stock craze a mania-an irrational willingness among investors to bid up stock prices to absurd levels.

"Gravity is going to win this one in the end-it always does," says Nick Moore, a technology analyst at Jurika & Voyles. "This is a real bubble, and it's going to pop. People are excited about something that's really new, that looks as if it's going to be really big. But by paying the wrong price, you can turn a great business into a lousy investment because these stocks are going to be like falling knives." The drop in Internet-stock prices doesn't end the danger, he warns. "When these things start to go down, they usually end up undervalued before they stop falling. Have you ever seen a balloon that's half popped?"

You've seen this before

Investors with even short memories shouldn't be surprised. Just seven years ago, in 1991-92, biotechnology stocks were the rage. Many such companies had no earnings to speak of, and drug research consumed money voraciously. Eventually, the sector crashed, and only in the past few years has it begun to revive as more biotech drugs have been approved for sale.

A similar fate befell investors in technology stocks in 1983. As with biotechnology, investors were correct in judging that the industry held great promise. They were just too early. Tech stocks crumbled and took years to recover. In fact, according to Topline Investment Graphics, an investor who bought the typical technology stock in mid 1983 still hasn't caught up with the [S&P 500](#). Go back in time, says Art Bonnel of [U.S. Global Investors](#) Bonnel Growth funds. There was a mania over jet-airliner stocks in the late 1960s, and over color-TV stocks in the 1950s. "It's kind of fun to watch these manias," says Bonnel, "but I'd rather buy any old stock in the Dow Jones industrial average."

[Photograph]

Tammy DiCaprio socked every spare dime into Internet stocks-then watched them plunge.

Ron Ognar, who runs Strong Growth fund, notes that investment manias usually occur before companies in infant industries become profitable because "you don't know how to value these companies. Once stocks have earnings, people can put a pencil to them." Only then, he says, do you see "how overvalued they really are."

Few doubt the potential of the Internet. Still in its infancy, it is already transforming society. Indeed, we call [America Online](#), DiCaprio's largest holding, one of the "Great Stocks on Sale" (see page 86). Says DiCaprio: "I don't watch the sports segment on the news. I go online and read about it minutes after it happened. When I'm sick, I go online to a medical site and research my symptoms before I call my doctor. Information that before might have taken me hours or days or even weeks to find is now at my fingertips."

But the success of the Internet doesn't tell you that all Internet stocks are great buys. Many Internet stocks crashed spectacularly even before the late-summer market tumble. [K-Tel International](#), for instance, rose more than tenfold in price after it announced in April that it would sell music CDs on the Internet. But most of the stock's gain was short-lived, and by mid September the price had settled to about twice where it had been before the announcement.

Market Guide, a provider of financial information, had a similar fate. It jumped 683% in April after it announced that it would offer its wares on the Internet. It's back down to about twice where it had been before the announcement. Another example: [Digital Generation Systems](#), which distributes audio and video advertisements from radio and television stations. It soared from \$2.75 July 14 to a high of \$7.13 July 16 after saying it would do business over the Internet. It now trades at \$3.

Life in digital city

But flameouts haven't dissuaded people like Dan Morrison. The 27-year-old chemical engineer in Lafayette, La., invests his 401(k) in a diversified stock fund, but almost all of his other investments are Internet stocks. Despite doubling their money in two years in Fidelity Select Electronics, Morrison and his wife, Jennifer, 23, sold that fund to focus on Internet stocks.

Morrison is not bothered by the downturn. "When the market drops, it's the best time to keep putting money in," he says. "The Internet stocks have taken a beating, but the opportunity is still there. The market could drop another 4,000 points and we'd still be there."

Most of their money is in Egghead.com-which sells software-and Broadcast.com-which went public in July, and which rebroadcasts radio and television programming to individuals and businesses via the Web. "If you're selling a product, getting rid of fixed assets [mainly stores], as Egghead has done, is the wave of the future," he says. "When you do away with stores and just sell over the Internet, you're reducing inventory; too." Morrison says he can listen to virtually anything he wants on Broadcast.com, including football games from his alma mater, the University of Texas.

Individual investors have plenty of company gobbling up Internet stocks; mutual funds and other large investors are sharing the feast. And their nerves are being steadied by the likes of Cathy Baker, Internet analyst with Robertson Stephens funds. Before the August-September bloodbath, she said, "If you look at the whole industry, the public companies are not overvalued relative to the impact the Internet is going to have." Then came the carnage. Is Baker chastened? By no means. "On a short-term basis, yes, I was wrong," she says. "But we're looking at these companies' exploiting an opportunity that's five to ten years out." In other words, she believes that stocks selling for half what they were two months earlier are twice as compelling.

Among Baker's favorites are [America Online](#) (symbol [AOL](#), [New York Stock Exchange](#), recent price \$102) and [Amazon.com](#) (AMZN, Nasdaq, \$85), both of which, she says, are acquiring new and loyal customers at a rapid clip. She also likes CMG Information Services ([CMGI](#), Nasdaq, \$48), a publicly traded venture-capital firm that specializes in Internet companies, such as Lycos and GeoCities, among others.

And Baker is excited about Excite (XCIT, Nasdaq, \$29), the number-two Internet search engine (behind [Yahoo!](#)) because Excite is growing at a faster rate than [Yahoo!](#)

[Photograph]

Blaine Weber gained more than 50% in five days by betting that [Amazon.com](#) stock would go down.

Philip Treick, co-manager of Transamerica Premier Aggressive Growth and Transamerica Premier Small Company funds, is a big fan of [Amazon.com](#), which he calls "inevitably profitable." Explains Treick: "They pay, I believe, \$20 or less in advertising to acquire a customer. The key is to keep that customer long enough to cover the cost. All of a sudden they have reached a critical mass. Costs will come down, and they will begin to make money."

The reality check

Blaine Weber thinks Baker and Treick are dead wrong. In fact, Weber, 46, a partner in a Seattle architecture firm, has been buying put options on [Amazon.com](#). A put option is a way of betting that a stock will go down in price. "These stocks went well beyond any realistic valuations, and a lot of it was emotionally driven buying by individual investors," says Weber. "I don't know how much further prices will fall, but the prices are trending down, and that's likely to continue for some time."

He's especially bearish on [Amazon.com](#), which is selling lots of books but losing money on every sale. "They're highly unprofitable, and I don't see the light at the end of the earnings tunnel at this point," he says. "Amazon was trading into the stratosphere on a hope and a prayer." Weber bought put

options three times on [Amazon.com](#), from late August through mid September. Each trade was enormously profitable, netting him at least 50% gains in five days or less. He plans to buy more puts.

Kenneth Heebner, manager of CGM Focus, a volatile fund, agrees with Weber. "Amazon keeps selling stock to finance its losses," Heebner says. "I don't buy companies that don't have earnings." Gary Pilgrim, manager of PBHG Growth-which buys companies with rapidly growing earnings, even at high price-earnings ratios echoes Heebner. "I'm perfectly willing to jump into the middle of high valuations- once I see earnings." Adds William Fleckenstein, of Fleckenstein Capital, which sells stocks short (another way of betting that the stocks will fall in price): "Nowhere else is there more imagination and fewer facts than the Internet. People are willing to be incredibly stupid with their money when it comes to anything with a 'dot com' in it." The decline in Internet stocks doesn't make them good buys, he says. "It doesn't make any difference how much these stocks have fallen. The key question is, what are they worth?"

Many investors, however, find it hard to resist the Internet. Especially after the big drop in prices, they believe there's a chance that a stock will take off the way [Microsoft](#) did. [Microsoft](#) went public in 1986, amid the same kind of hoopla and skepticism that surrounds many Internet stocks today. If you had bought \$10,000 worth of [Microsoft](#) stock when it went public and held on to it, it would be worth \$2.9 million today.

For every [Microsoft](#), of course, there are scores of companies that fall by the wayside. Finding the next [Microsoft](#)-in other words, a company that will dominate the Internet as [Microsoft](#) does PC software-is a fool's errand. "None of these stocks is going to be the next [Microsoft](#), because [Microsoft](#) is a phenomenon that will not be repeated for a long time," says Garrett Van Wagoner, manager of five Van Wagoner mutual funds.

The problem is that it's easy for a well-heeled competitor to enter an Internet business and wrest customers from an established company because there are no natural barriers. A strong brand name like [America Online](#) is an enormous help, but most of the other Internet companies have yet to prove themselves.

Take the online-brokerage business. More than 80 online brokerages now exist, including those run by large companies, such as [Charles Schwab](#) and Morgan Stanley Dean Witter. The competition has forced virtually all brokers to slash their commissions, thereby squeezing profit margins (see, "Goodbye Wall Street, Hello Omaha," Oct.).

Such a scenario could cripple [Amazon.com](#) or any of the other Internet e-tailers, as they have been dubbed. "Say somebody comes online and calls itself Gobi.com, and buys advertising saying it will sell all books \$1 cheaper than [Amazon.com](#)," says Van Wagoner. And better designed Web sites, with plenty of promotional dollars behind them, could knock even Internet portals like [Yahoo!](#) out of leadership positions.

Investor DiCaprio says all this talk about value misses the point. "The Internet companies may be overvalued, undervalued or fairly valued right now," she says. "'Right now' hardly matters. I think that people who are longterm investors in Internet companies are investing in potential as well as present performance."

What if she's at least half right-what if this infant industry is spawning the superstocks of the next decade? What's the sensible way to invest in them? Try being patient. James Stack, editor of InvesTech Market Analyst newsletter, advises waiting until the Net stocks are flat on their backs. As the washout occurs, says Stack, even companies with the best futures will be sold indiscriminately. Even the most optimistic investors-perhaps including DiCaprio and Morrison-will have thrown in the towel. "That's the time to buy," says Stack.