HUMBLING LESSONS FROM PARTIES PAST

By BURTON G. MALKIEL

BENJAMIN GRAHAM, co-author of "Security Analysis," the 1934 bible of value investing, long ago put his finger on the most dangerous words in an investor's vocabulary: "This time is different."

Pricing in the stock market today suggests that things really are different. Growth stocks, especially those associated with the information revolution, have soared to dizzying heights while the stocks of companies associated with the older economy have tended to languish. Well over half the stocks on the New York Stock Exchange and Nasdaq are selling at lower prices today than they did on Jan. 1, 1999.

It is not unusual today for new Internet issues to begin trading at substantial multiples of their offering prices. And after the initial public offerings, day traders rapidly exchange Internet shares as if they were Pokémon cards for adults.

Cindy Karp for The New York Times

Burton G. Malkiel, the Princeton professor, in Palm Beach, Fla. Investments in changing technology are not always rewarded, he says.

As we enter the new millennium, how can we account for the unusual structure of stock prices? Does history provide any clues to sensible strategies for today's investors?

To be sure, we are living through an information revolution that is at least as important as the Industrial Revolution of the late 19th century. And much of the current performance in the stock market can be traced to the optimism associated with "new economy" companies -- those that stand to benefit most from the Internet. The information revolution will profoundly change the way we learn, shop and communicate. But the rules of valuation have not changed. Stocks are only worth the present value of the cash flows they are able to generate for the benefit of their shareholders.

It is well to remember that investments in transforming technologies have not always rewarded investors. Electric power companies, railroads, airlines and television and radio manufacturers transformed our country, but most of the early investors lost their shirts. Similarly, many early automakers ended up as road kill, even if the future of that industry was brilliant.

Warren E. Buffett, chief executive of **Berkshire Hathaway** and a disciple of Graham, has sensibly pointed out that the key to investing is not how much an industry will change society, but rather the nature of a company's competitive advantage, "and above all the durability of that advantage."

Yet the Internet must rely for its success on razor-thin margins, and it will continue to be characterized by ease of entry. A drug company can develop a new medication and be given a 17-year patent that can be exploited to produce above-average profits. No such sustainable advantage will adhere to the dot-com universe of companies.

Moreover, the "old economy" companies may not be nearly as geriatric as is commonly supposed. We still need trucks to transport the goods of e-commerce, as well as steel to build the trucks, gasoline to make them run and warehouses to store the goods.

Precedents of recent decades offer many valuable lessons to today's investors. Consider the "tronics boom" of 1960-61, a so-called new era in which the stocks of electronics companies making products like transistors and optical scanners soared. It was called the tronics boom because stock offerings often included some garbled version of the word "electronics" in their titles, just as "'dot-com" adorns the names of today's favorites. More new issues were offered than at any previous time in history. But the tronics boom came down to earth in 1962, and many of the stocks quickly lost 90 percent of their value.

Another parallel to today's market was seen in the 1970's, when just 50 large-capitalization growth stocks, known as the Nifty 50, drew almost all the attention of individual and institutional investors. They were called "one decision" stocks because the only decision necessary was whether to buy; like family heirlooms, they were never to be sold. In the early part of that decade, price-to-earnings multiples of Nifty 50 stocks like **I.B.M., Polaroid** and **Hewlett-Packard** rose to 65 or more while the overall market's multiple was 17. The Nifty 50 craze ended like all others; investors eventually made a second decision -- to sell -- and some premier growth stocks fell from favor for the next 20 years.

The biotechnology boom of the early 1980's was an almost perfect replica of the microelectronics boom of the 1960's. Hungry investors gobbled up new issues to get into the industry on the ground floor. P/E ratios gave way to price-to-sales ratios, then to ratios of potential sales for products that were only a glint in some scientist's eye. Stock prices surged. Again, as sanity returned to the market and more realistic estimates of potential profits were made, many biotechnology companies lost almost all of their value by the early 1990's.

The lessons here are clear. Occasionally, groups of stocks associated with new technologies get caught in a speculative bubble, and it appears that the sky is the limit. But in each case, the laws of financial gravity prevail and market prices eventually correct. The same is likely to be true of the dazzling stocks in today's market.

Few of the Internet darlings will ever justify their current valuations, and many investors will find their expectations unfulfilled. Even supposedly conservative index-fund investors may be surprised to know that very significant shares of their portfolios are invested in information technology companies whose P/E and price-to-sales ratios vastly exceed even the sky-high multiples reached during those past periods of market speculation.

At the very least, investors might well start the year by examining their portfolios, to see if their asset allocations are appropriate for their stage in life and their tolerance for risk.

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