THE TRADER | SATURDAY, MARCH 8, 2014

Stocks Rise 1%, S&P 500 Reaches New High

By VITO J. RACANELLI

Better U.S. economic date trumped geopolitical jitters, spurring talk of a bubble. However, that may be overdone.

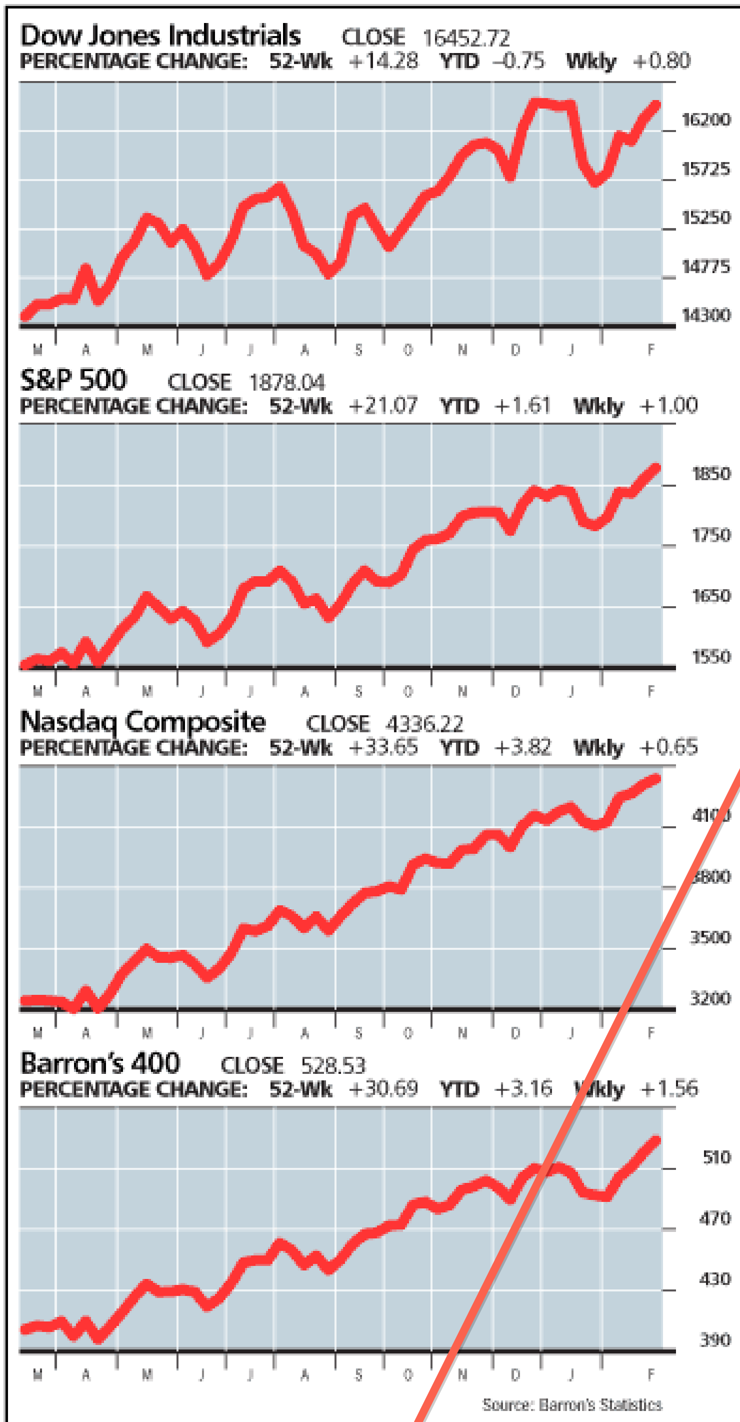
Vital Signs

It's beginning to seem that, short of war, this market's going up, so perhaps it's no wonder that talk is building of a 2000-style stock market bubble.

Shares jumped 1% last week, notching another all-time record high despite a serious confrontation between the U.S. and Russia over its moves in the eastern Ukraine. Geopolitical concerns were trumped by improving U.S. economic data, and conciliatory-sounding comments from Russian President Vladimir Putin assuaged the market. Nevertheless, the situation on the ground in Crimea remains unpredictable and tense, and could yet come back to slam the market.

On the week, the Dow Jones Industrial Average picked up 131 points, or 0.8%, to 16,452.72. The Standard & Poor's 500 index gained nearly 19 points, or 1%, to 1878.04, a new high. The Nasdaq Composite index rose 28 points, or 0.65%, to 4336.22. The Russell 2000 small cap index soared 1.7%, or 20 points, to 1203.32, and a nearly 3% one-day jump Tuesday helped fuel the bubble talk.

The more important geopolitical issue could extend beyond the dust-up over the Ukraine, leading to future market-slamming confrontations between the West and



Russia over other issues, like Syria and Iran, says James Russell, senior equity strategist at U.S. Bank Wealth Management. "Cooperation with Russia could be off the table, and that could lead to more strident event risk later this year," he adds.

U.S. domestic data continue to show trends that are "two steps forward, one step back," Russell adds, but remain supportive nonetheless of the rally. Last week's report of a drop in jobless claims and a larger-than-expected rise in payrolls was welcomed by investors.

In addition to the equity rally, a hot IPO market is also behind the bubble talk. Initial public offerings are ramping up so the market will have to digest a lot of new stock supply, he adds. Bad-weather issues might also be reflected in the first-quarter reporting season.

A "cautious" Bernie McGinn says the fact controversial stock **Tesla Motors** (ticker: TSLA) doubled its share price since late Novembersuggests the market is starting to look "frothy." Still, the president of McGinn Investment Management and 30-year market veteran doesn't put himself in the bubble camp: "I don't see a big drop when the economy is limping to a recovery."

Bubble talk can go on for a while, he adds. There was plenty of such worry in 1999 and the Nasdaq still doubled from August of that year to March 2000, he says.

History notes that the Nasdaq then fell 80% over 30 months, and that the initial bubble pinprick wasn't macroeconomic. (More on bubble talk below.)

AOL IS A NAME that may remind some readers of the Internet bubble of 2000, but it was spun off from **Time Warner** (TWX) in 2009. AOL's stock has tripled since 2011, to $44.04 Friday, far surpassing an already blistering 50% rise by the broad market over the same period.

The excitement is over AOL (AOL) turning itself into a "digital media" company, with substantial earnings from its traditional but declining Membership unit used to support future strong growth expected from its Brand and Networks divisions.

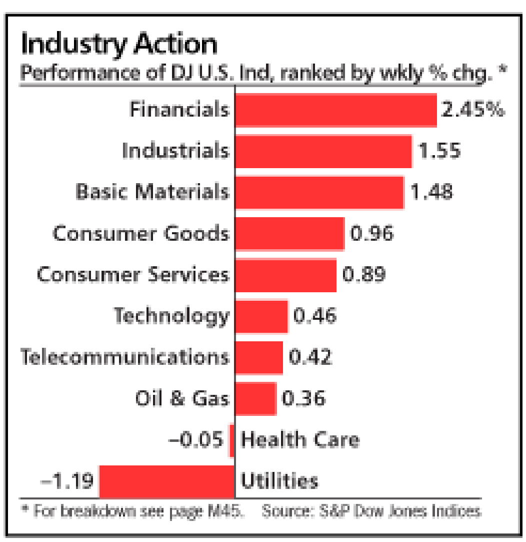
Consensus analysts' earnings-per-share estimates have duly risen—up to $2.24 per share in 2014 from a $1.82 expectation 12 months ago—as the Street anticipates a promising digital-media future for AOL. But it's a view that could turn out overly rosy, which won't be good news for the stock price.

AOL's profit growth in the past 24 months has come primarily from cost-cutting, says David Trainer, president of New Constructs, an independent research firm. "Cost cuts are not a long-term strategy," he says.

That's particularly true of "digital media" companies. Yet the cost-cutting goes on, as AOL reduced its workforce 10% in the first two months of this year, to 4,600. There's nothing wrong with reducing costs, but what kind of multiple does that deserve?

Total adjusted operating income before depreciation, and amortization (OIBDA) jumped 17% last year to $481 million, from $413 million in 2012 and revenue rose 6% $2.3 billion. Looks good, but the increase in income is accounted for—and then some—by last year's $91 million reduction in general expenses. Large 2012 extraordinary items make operating numbers more relevant.

Skeptics also point out that AOL still derives the overwhelming amount of its profit from its better-known but deteriorating Membership business, which includes AOL Mail, where paid subscribers have dropped to 2.5 million from 3.3 million two years ago. Membership-adjusted OIBDA was $593 million last year, down 6% but more than the 2013 AOL consolidated total OIBDA because of losses at the corporate level and the Networks group. Average membership revenue per user was up 12%, but not enough to offset the decline in numbers, which AOL acknowledges will continue.



The Brand group, a publisher of online content—including the Huffington Post and Engadget.com Websites, among others—gets revenue from advertising and searches. Sales rose a robust 9% last year to $794 million and adjusted OIBDA swung to $40 million in income from a $33 million loss. That's nice, but given its small percentage of overall profit, not worthy of the stock's tripling or the current price/earnings ratio of 20 times 2014 EPS.

AOL Networks' growth, meanwhile, is creating the most excitement. Networks basically matches up online ad inventory and content from a diverse array of publishers, with advertisers looking for specific viewer criteria. The ads appear across various platforms from personal-computers to mobile devices. It's a promising business and bulls point out that fourth-quarter Networks revenue rose 50%. That's attractive, yet Networks' adjusted OIBDA fell $0.5 million from the same quarter of 2012. AOL needs to show consistent profit rises at the divisional level.

Indeed, AOL notes that because of higher variable costs at Networks compared with more fixed costs at Brands and Membership, the same Networks revenue rise would probably lead to lower incremental margin gains. Networks is basically a middleman, not a typically high-margin position, says Trainer.

The Street expects $1 billion in Networks sales this year, up from $785 million last year, but a lot of that comes from acquisitions. And annual Networks results need to be put in context. In 2013, revenue did rise a solid 22% to $785 million, but that's down from a 31% jump in 2012. Networks' adjusted OIBDA has been choppy: a negative $40 million in 2011; a positive $7.3 million in 2012; and back again to a loss of $15 million last year. Consistency is important for a high P/E multiple. Where are the sustainable and rapid revenue and profit increases usually required of highflying digital media companies?

Like the Brand division, Networks is currently an insignificant part of the total profit pie, and even a return to black ink this year would most likely not be as financially meaningful as cost cuts have been.

AOL responds by noting that it has shown consistent improvements in revenue, expenses, profit, and usage on a consolidated basis. The company has also said that it expects Networks and Brand margins to improve in 2014 from 2013.

AOL bulls also point out that rival **Rocket Fuel** (FUEL) is much smaller in revenue but trades at a big premium, a P/E of 93 times 2015 EPS estimates. But Rocket Fuel is a pure play and showing 100% revenue growth. And while AOL Networks produced 2013 triple-digit growth in the hot digital-media business called "programmatic" ad sales, much is from an acquisition and it was less than 10% of total revenue.

AOL has improved its position from a few years ago, but the stock discounts that and more, and bulls are extrapolating Networks' double-digit sales rise far into the future. If that proves to be unsustainable, disappointment will ensue. It won't take much of a miss in quarterly results for the stock price to suffer.

TALK OF A NEW STOCK-MARKET bubble is intensifying. Perhaps such worries proliferate now because last Friday, March 6, was the fifth anniversary of the market's intraday low—666.79 on the S&P 500 index—in the terrible 2008-09 bear market. Since then stocks have risen 180% and some investors are understandably scared of heights.

Many seem particularly troubled by the parabolic move in biotechnology stocks. While the group fell about 3% one day last week, the Nasdaq Biotech index is up 14% this year alone, and about 75% since 2012. Since March 2009, the index has shot up more than 360%.

But to see how "bubbly" the market or biotech have become, it's useful to look at one of the best-known bubbles of them all, the dot-com bubble that ended in 2000.

In a recent report, Bespoke Investment Group dated the Internet Bubble from December 1994 to March 2000, a period in which the Nasdaq 100 index produced a mammoth 1,118% rise in some 1,900 days.

Since the low in March 2009, the Nasdaq Biotech index is up 361% in over 1,800 days. Heady as it is, that move pales in comparison. Biotech isn't even second, the BIG report notes. The home-building stocks in the S&P 1500 soared 835% from March 2000 to July 2005, also roughly the same in days.

And while biotech gets much of the attention, technology stocks are at it again. The Nasdaq Internet index (QNET), which includes AOL, for example, has risen almost 500% from the March 2009 lows.

Do such comparisons sound the all-clear?

Market bears will say that the entire market is a bubble now. But in hindsight the nearly 60% market drop five years ago was exceptional and overdone.

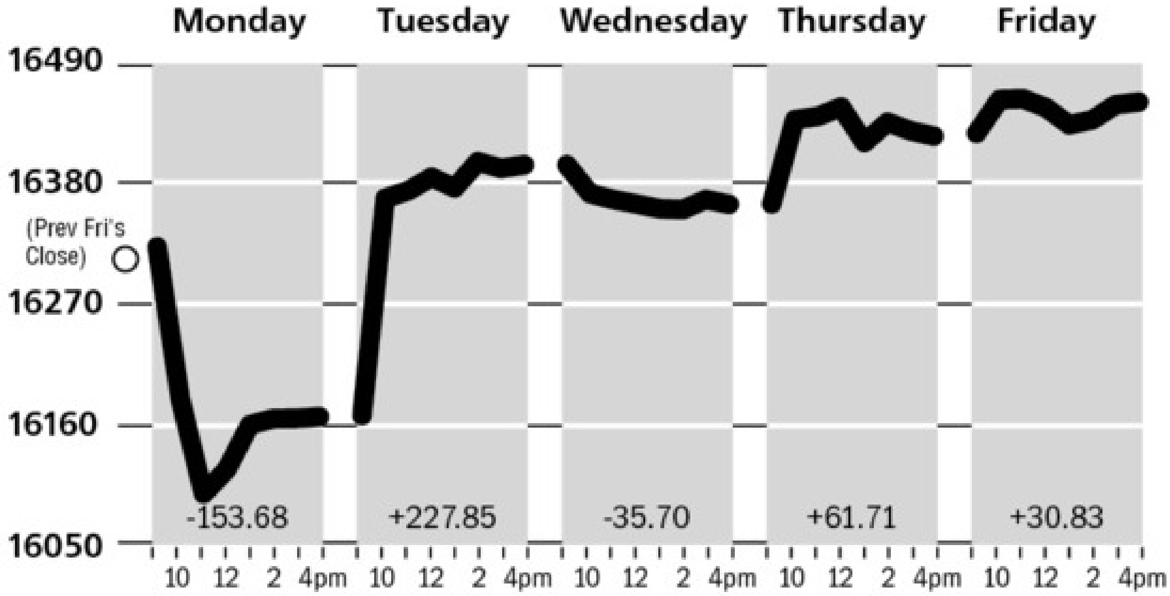
The current S&P 500 index forward P/E of 16 times is a bit above the long-term average but much lower than in 2000. Both profit growth and interest rates are low, but rates will eventually go higher and corporate profit margins will get squeezed. For all the nervousness right now, investor sentiment looks complacent by historic measures, and the individual investor is returning to stocks, which suggests more a bull in its latter stages than a bubble.

At these levels, what's true is that stocks are more exposed to unforeseen exogenous shocks than they were a year ago. Turmoil in Ukraine took the market down only for a few days, but no one can predict when or whether such events will happen, or the severity of the reaction.

Many investors are getting increasingly uncomfortable, but the sad truth is that bubbles are only proven after they pop.

FIVE-DAY DOW COMPOSITE

Unbroken: Despite rising tensions over Russia's territory grab from Ukraine, the Dow turned in an 0.8% gain on the week. Friday's jobs report was better than expected.



E-mail: editors@barrons.com