In praise of dot-commers' irrational exuberance

Putting time and money into new internet companies is bound to be a loss-maker in the long run, argues Michael Lewis. So why the gold rush to invest in them?

In its 1 April edition, *The Economist* published what it called 'A Thinker's Guide' to internet economics. It took the view that most internet investors are probably doomed. "In all technological revolutions from the railways to the internet, the only sure long term winners are consumers who gain from lower prices and hence higher real wages," said *The Economist*.

This isn't exactly an original thought. The trouble with new technology, from the investor's point of view, is the difficulty of turning the benefits it delivers into profits. Investors and entrepreneurs sink huge sums of capital and time into creating some new technology-based businesses only to find, just when they appear to have viable enterprises, that newer companies with lower start-up costs are poised to pile in and drive down returns.

This observation raises some questions. Why do people invest huge sums of capital to develop new technologies? And don't they know the history of technology investment as well as *The Economist*?

One answer is that they choose to believe that "this time will be different from all the others". Which is to say that they become irrationally exuberant.

FIGURE 1

Details of trading by on-line investors

Source: Bloomberg

Few problems

It's easy to list the negative things that happen when people become too hopeful. Some quit productive jobs to become day traders; others get sucked into fraudulent schemes. But most of what has been indisputably bad about the internet revolution also has been fairly trivial. According to Amy Butte, an analyst at Bear, Stearns & Co, there are only about 50,000 on-line investors who make between 25 and 40 trades a day (see *Figure 1*). And as for fraud, there has been surprisingly little of it. Who needs Ponzi schemes when internet stocks have soared so dramatically in the past two years.

The real price that a society pays for its irrational exuberance is measured in the time and money its citizens sink into enterprises they sincerely believe in but which, in the end, prove unprofitable. A great deal of human and financial capital fails to earn a return. But, as *The Economist* suggests, that hardly means that there is no return.

The gold rush metaphor so often used to describe the internet revolution does not fully capture the spirit of the event. Gold miners who failed to find gold produced no benefits for anyone (though they did more or less invent the state of California as we know it). It's a waste of capital to dig holes in the ground to only find dirt.

Thank you, dreamers

But that isn't what internet entrepreneurs and their irrationally optimistic investors have done over the past few years. In their spree of foolish hope they have erected a massive infrastructure that will benefit all of us for a very long time. Thanks to them, the US economy is booming, industry is slashing costs, and consumers are revelling. It's hard to say that these benefits justify the costs. But it's just as hard to say that they don't. And the benefits are as much the fruit of America's current gift for irrational exuberance as the costs.

New technology may be the single most important ingredient for current economic growth. And that raises another question: if, as *The Economist's* 'Thinker's Guide' suggests, new technologies often benefit society without benefiting the people who create them, why is there not a systematic under-investment in technology?

If they sense that new technology doesn't pay, rational investors and entrepreneurs will not hurl socially optimum amounts of capital at it. If investing in new technology is a fool's game from the investor's point of view – but a wonderful thing from society's point of view – it only stands to reason that investors will not invest as much as the rest of us would like them to.

One of the themes of the internet boom has been its lack of philanthropic spirit. And it is true that the new rich are surprisingly unmoved to engage in old fashioned charitable giving. In retrospect, however, the internet revolution may appear as the greatest period ever for American philanthropy. Investors, workers and entrepreneurs have selflessly contributed huge quantities of time and money into the building of electronic roads on which the rest of us will travel for ages.

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True, they didn't think they were engaged in charity. Their philanthropy was unintentional. They acted against their narrow economic self-interest without knowing what they were doing. But that does nothing to diminish the benefits they have showered upon the rest of us.

The best part of all is that we don't need to thank them personally. We only need to thank their irrational exuberance. ■

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