THE INTERNET ECONOMY AND INVESTING VIA THE INTERNET

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The internet economy, which emerged in 1994, recorded over the following years an unprecedented boom. Many economists compare its emergence with the period of the Industrial Revolution in the 18th century, though where its growth is essentially greater than that in the case of the Industrial Revolution. The internet has become a relatively significant part of the economy, where its potential scope, size and overall economic impact on the economic system is and will be in the future greater than that which we see at the present.

The rapid development of the internet economy has been seen mainly in the growth of revenues of companies connected with the internet. Statistical data show that American companies connected with the internet in 1999 increased their revenues by 62% ($523.9 billion); in 2000 the volume grew to $850 billion. The internet economy grew in 1999 by 11% while the economy as a whole reported growth of 4.2%, with revenues having overtaken sectors such as the automobile industry and insurance. The most recent estimates suggest that the internet today employs more than 2% of all workers in the USA and their number is continually growing. The internet economy phenomenon did not for a long time show any signs of its broad range of possibilities.

As many experts now state, it is becoming the basis of the so-called new economy and there is occurring the gradual death of the old economy.

Forecasts of the indispensable role of the internet economy and the positive reports on the results of companies connected with the internet led many investors towards crowd madness in investing in new technology companies. Many investors lost any interest in analysis of risk and invested blindly in woolly visions of high yields. The effect was in essence the same as that recorded in the histories of speculative bubbles. Through the significant demand for the shares of these companies prices moved to an unrealistically high level, neither corresponding to their internal value nor company performance. The bubble burst and in essence there was a move towards a more realistic valuation of shares of those companies that will in the future have a more certain growing trend (though certainly not at the level as seen in 1999-2000). Even where new technology shares are concerned, it is necessary to work from the fact that these shares represent a risk instrument and therefore it will also in the future be risky to invest only in a small number of selected companies. It is recommended rather, to have an investment strategy with broad diversification.

Investing in internet funds

Concurrent to the development of internet companies there were established in the USA in 1996 also the first two internet funds, these being the Internet Fund (which has now gone bust) and Munder NetNetA. Following the boom and bust of technology shares in the year 2000, there are now estimated to be 12 such funds.

The investment strategies of these funds are now regularly published on the internet and as an example we can give WWW Funds, which administered two funds: the WWW Internet Fund and the WWW Global Internet Fund. The objective of this fund is long-term growth through capital appreciation. The fund invests almost 70% of its assets in domestic companies connected with the internet, at maximum 15% of assets are in money market instruments. At present American analysts group these companies into:

- Mature, which have successfully implemented an internet strategy,
- Medium-term enterprises, which have a market leader position in one of the internet sectors,
- Maturing enterprises, these are in particular small firms where growth is expected as well as a leading position in the future.

The fund achieves diversification through investing approximately one third of its assets in each group. What is the method for selecting shares for purchasing into or selling from the fund? The fund chooses one strategy for mature and medium-term companies and a different strategy for maturing companies. For mature and medium-term companies the assessment is made largely on the basis of income growth, and the price earnings ratio. In the case of maturing companies, preference is given to those companies able to create profit in the shortest possible time, having patented technologies, and strong management and have the possibility to gain a dominant market position.

In the present situation of a significant decline in technology share prices and considerable share price volatility this strategy, too is risky also with regard to the fact that this still concerns just one sector, the internet economy. Overall we can group the risks of this fund according to the following points;

- General risk means that even this fund can end with a loss,
- Market risks (changes in interest rates, inflation, exchange rates, etc) can cause higher volatility in share prices,
- Growth shares are marked as being more risky, since they are more sensitive to their own development, where their value can fall dramatically,
- Sector risk - in the fund there are associated companies often connected with the same regulation, the same barriers, which can also cause increased volatility in a fund's shares,
- The risk of a fast loss of moral ageing of internet technologies, leading to rapid changes and exchanges in technology in comparison with other sectors. This is brought about also by greater competitive pressure, which can significantly change the financial situation of internet firms,
- Small company risk. Small companies are considered as being generally more risky,
- Risk of low share liquidity in the case of these companies, and in particular those where there are significant price fluctuations.

There also exist here other risks connected in particular with possible price fluctuations as a consequence of various other factors (political, psychological, or legal). With regard to the long-term strategy of the fund and the future of the internet economy it can be expected that in future this fund will achieve greater appreciation.

Yield 1996 – 2000		
WWW Internet Fund	Nasdaq Composite Index	S&P 500 Index
19,9 %	20,97 %	19,6 %

Development to date still points to significant fluctuations in the performance of this fund. The highest yield was achieved in the 4th quarter of 1999 (+79.26%), and the greatest loss in the third quarter of 2001 (-47.21%). If we make a comparison over the longer term since 1996 (when the fund was established) up until 2001 and compare it with selected portfolio indices, we find that the yield does not differ too greatly.

Similarly as with most other investors the fund did not avoid psychological pressure and in an expectation of further profits without an analysis of risk purchased shares even at a time when it was clear to most analysts that it was a speculative bubble, which would in a short time burst and prices would head irreversibly downwards.

Today it can only be said that the vision of profits caused by the growth of technology shares has passed, its toll has been paid even though this appears as having been too great. According to analysts the fall in the Nasdaq Composite Index caused investors worldwide to lose USD 4 trillion, which of course ended up mainly in the hands of speculators. These are the conclusions reached in an analysis by an American organisation for investor protection, NASAA (North American Securities Administrators Association), published in 1999. NASAA analysed the yields of 30 portfolios of American broker firms working for individual clients. From the conclusions it results that:

- The average account was open at most four months and achieved an average annual turnover of 278, with a cost equity ratio of 56%.
- 4093 trades on 26 accounts were evaluated and analysed, where 70% were loss-making, of which many of these realised a 100% loss of all the money.
- Only three of the 26 open accounts reported a profit (11.5%)
- In the case of day trading in an analysis of 2754 trades on 17 accounts, a loss was reported in 65% of these, where many resulted in a loss of all the money invested.
- Only one of 17 accounts had successful day trading, but the profit did not correspond to the risk connected with these investments.
- Success was achieved only by those performing limited short-term trading (not undertaking day trading).

It therefore results from the reports that up to 70% of clients produced or at present are producing a loss, while even many have lost all their money. Only 11.5% of clients have a chance to achieve a profit.

Bourse games versus investing via the internet

Globalisation of capital markets, new technologies of trading connected with the internet open up the possibility for a large number of investors to invest on a real-time basis on world capital markets and the largest stock exchanges around the world. This possibility was provided by the company Blue Bull also to investors in Slovakia in the form of virtual investing, where the investor has the opportunity to verify his/her skills, and gain practical knowledge for investing on a real basis in the future.

This system of a bourse game in the form of virtual investing means that the investor gains a fictional financial sum (e.g. USD 10 000) as an entry on the account and, using this financial sum, purchases and sells securities via the internet, virtually trading on world capital markets. As opposed to real trading these trades are of course not recorded in the trading system of the individual stock exchanges. This system also evaluates the input instructions in relation to the actual exchange rate and performs financial charging of the whole trading transaction. The company on the basis of a sample of 740 individual investors also shows that approximately only 30% of investors were able to maintain their investment at the original balance, or to achieve a profit and conversely 70% of investors recorded a loss (which corresponds also to NASAA studies). This means of virtual investing despite the fact that it significantly approaches the real state of trading on the capital market also has its weak points:

• individual instructions for a purchase or sale, through the fact that they are not entered into the trading system of bourses, cannot influence the liquidity or trading price of a security. In the case of investing on a real basis the entry of many investors onto the market can significantly influence a security's trading price.

• Trading in this manner is possible only on highly transparent and liquid markets.

At present in Slovakia there is the possibility to invest via the internet real money, where several hundred investors now invest in this manner. Since this form of investing is now made available in Slovakia by several companies, where the investor should ascertain whether it has a licence for this activity from the Financial Market Authority and a foreign currency licence from the NBS and thus reducing the risk that an investor will lose his/her investment. Despite the fact that however it is not possible to exclude the bankruptcy of such an institution, as proven by last year's collapse of the company Online Investor Slovakia, in which the largest investor was the Czech company Private Investors, Slovak clients lost millions of SKK .

The new Act on Securities and Investment Services prevents such practices through its introduction of compulsory client protection in the form of a guarantee fund to which securities traders are obliged to contribute. In the case of bankruptcy of a securities trader compensation should be paid out from this fund for unavailable client assets, up to the amount of 90% of the investment value.

Slovak investors can invest in world capital markets via the internet several via companies. These companies now provide a wealth of information about important investment decisions and give the possibility to trade not only on American markets, but also the main European capital markets.

Each investor must include in his/her calculation also trading fees charged by these companies for purchase, sale or cash transfer. Some companies even provide credit, where trading fees are already included in the price. These fees are lower than in the case of asset administration companies, nevertheless it necessary to mention that the effective lower limit on money invested is USD 3 000, meaning that for small investors it is instead more attractive to invest via mutual funds.

In the case of investing individually it is especially necessary to draw attention to the risks. With regard to the nature of securities and shares these are greater. An investor should not invest blindly, or on the basis of hot tips, it is necessary to consider also the level of specific and market risk.

• Specific risk, meaning credit risk, managerial risk and insolvency risk, can be partially reduced by means of the rating. Today all companies entering world capital markets have a rating assessment on the basis of which an investor can gain cumulative information on possible specific risk.

• The situation is more complicated in the case of market risk, where several factors are at play, such as interest rate movement, inflation, exchange rate movement, low market liquidity, etc. Quantifying this risk is now a matter of the detailed work of analysts. What an investor should however consider is the thorough distribution of risk on the basis of diversification.

It no longer suffices to have just the one random method of tracking the course of market prices of the respective type of shares and buy or sell these, rather it is necessary to have a professional method of creating a portfolio, where it will be possible to use also other financial instruments, which would contribute to limiting its risk and the rate and performance growth. In managing portfolios professional managers also utilise derivatives such as forwards, futures, swaps or options, which enable risk to be managed effectively.

From the position of the investor it is also necessary to bear in mind to what risk is he/she willing to be exposed, where for risk-averse investors a conservative portfolio is recommended. Such a portfolio is composed mainly of money market instruments, these possibly containing a smaller proportion of bonds. The investor who admits a certain level of risk should opt for a balanced portfolio, where money market instruments and bonds represent approximately 50% and the other half of the portfolio comprises shares (conservative shares prevail over those aggressive). The third type of investor is one able to bear risk well (often compared to the type playing in a casino) and for this type of investor an aggressive portfolio is recommended, where more than 80% of the portfolio is represented by shares, but where again conservative shares predominate. American analysts prove that aggressive portfolios copy the development of the Nasdaq index, but from the long-term aspect conservative portfolios have higher yields. Despite risk management the most aggressively risky portfolio has achieved a loss.

Thus again it is confirmed that in the case of investing in technology shares, the principles of healthy investment were not respected and investors in an effort to buck the market, simply ended up having the last laugh fall upon themselves.

In conclusion it is necessary to draw investors' attention to taxation of income in investment. This issue is significantly extensive and in many areas non-transparent. On the one hand there is considerable disunity and fragmentation in the framework of the European Union itself and its capital market, and on the other hand there is the field of offshore centres, which enable tax avoidance, besides this it is necessary to know which countries Slovakia has signed an agreement on the prevention of double taxation with.

The internet economy and the internet itself today offer a huge opportunity for investors to access world capital markets; they should not however be attracted merely on the basis of their vision of high profits while no mention is made of the realistic risks connected with investing. In contrast, to draw attention to risks means a serious approach and a partnership relationship with investors, who appreciate this approach in investing on capital markets.