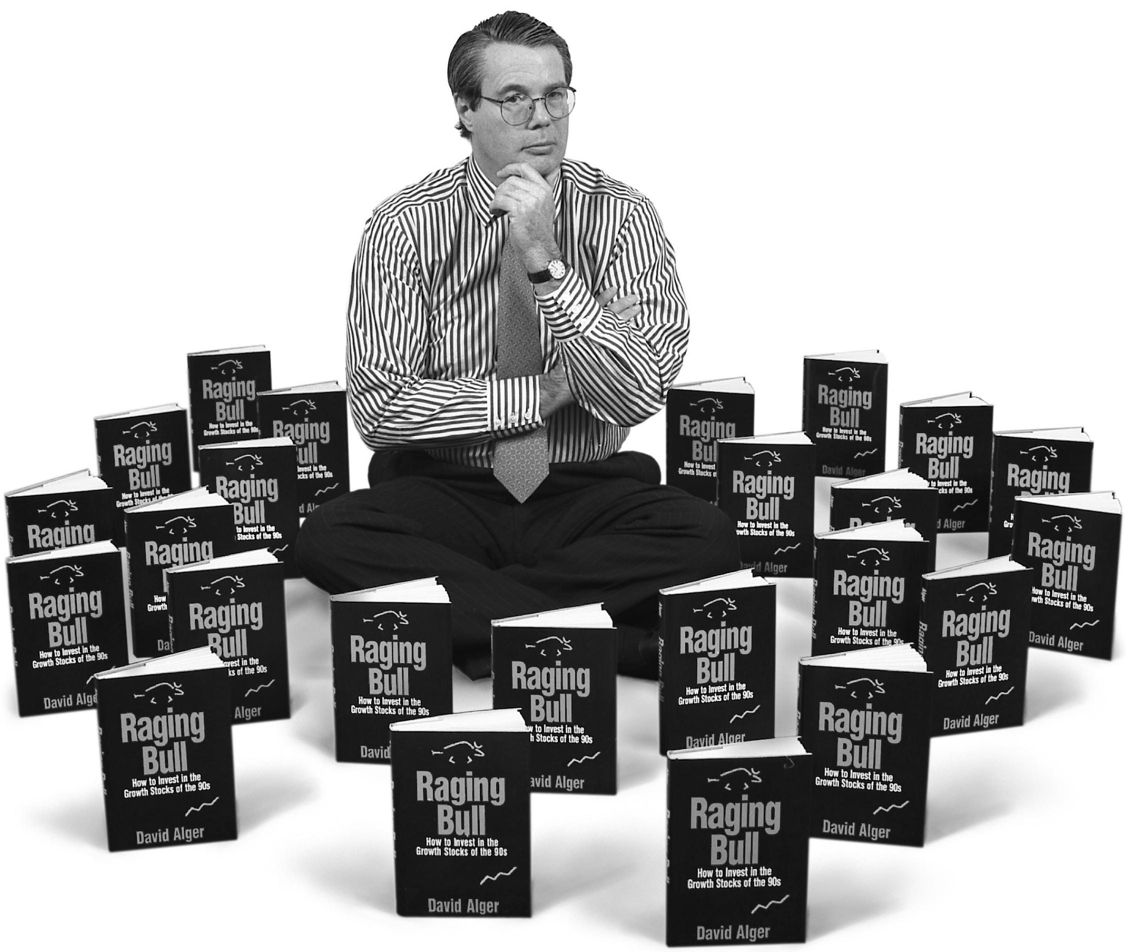
BARRON'S

THE DOW JONES BUSINESS AND FINANCIAL WEEKLY www.barrons.com MARCH 29, 1999

Today's Fifty are Niftier, zero inflation is near, and look for Dow 20,000

Still Raging

An Interview With David Alger • Investors are clamoring for David Alger's monthly fax to clients, which contains the growth investor's market predictions. Little wonder. Year after year, his forecasts have been right. Alger, 55, is the author of *Raging Bull* and chief executive of Fred Alger Management in Manhattan, which has spawned some of the mutual-fund industry's best-known investors. Alger's funds, which own the market's fastest-growing sectors, have also beaten their peers, recently and over the long haul. Last week, as jitters sank the Dow, Alger told us why he thinks inflation is going to zero, and why the Dow is heading still higher. He also plugged a clutch of Internet plays and new Nifty Fifty stocks. Whether or not you agree, we guarantee that you'll find his insights useful. **– Leslie P. Norton**



Photograph: Tom Iannuzzi for *Barron's*

FOR PRODUCER USE ONLY

(over please)

Barron's: *How does this market compare with the Nifty Fifty market you cut your teeth on, David?*

Alger: It is curiously dissimilar. The multiples of the Nifty Fifty in their heyday, right before the 1973-74 bear market, were actually higher than the Nifty Fifty stocks are now. I remember that Litton Industries bottomed in 1974 at 40 times earnings. Many stocks were at more than 100 times earnings at the top. Litton was a really good example because the stock was a big industrial diversified conglomerate, unlike the companies today. The Nifty Fifty today are better companies – faster-growing, higher returns on equity, much more value added. Today everyone says that when we have a 1974-type bear market, the Nifty Fifty will get wiped out. That won't happen. The rationale is missing. Back then, oil quadrupled, the President resigned, we had improbably high inflation and we were coming out of the Vietnam War. There is no comparison.

Q: *You recently sat down and composed a "Grand Unified Theory" of the market to explain your bullish views.*

A: I was trying to figure out a couple of things puzzling everyone. One, why is the economy booming along with no apparent inflation? Two, why is the Fed not reacting to signs that the economy was much stronger than expected? Three, why are market multiples as high as they are? And the corollary, why are interest rates as low as they are? I was so struck by Alan Greenspan saying in his Humphrey-Hawkins testimony that all the economic books had to be thrown out and replaced by new ones that we didn't have yet.

Q: *What are the answers?*

Alger: They're fairly straightforward. Back in 1980 Ronald Reagan come along with supply-side economics. Supply-side economics gave individuals and corporations incentives to increase production, and productive capacity, and investment. As a result, you built supply faster than demand, thereby lowering the price structure and ensuring a strong and vigorous economy. George Bush considered it "voodoo economics." We've had a very dramatic series of tax cuts from as high as 90% in the 'Fifties all the way down to a low of 28%. Sure, there's a recent uptick in taxes. But for the average person, taxes are actually lower than at any time in the past. So you've had a strong ramp-up of capital spending. And capital spending on computers is growing in the high teens. If you standardize what a dollar of spending on computers buys now versus five years ago, we've probably grown our computing power by about 100% a year. Our society is drowning in MIPs and megahertz. The effect is a great surge in productivity across the entire spectrum. And that's brought down inflation at a time the economy has been growing quite rapidly. Moreover, the level of actual capacity utilization is almost at its lowest since 1980, excluding the recession years, because of huge capital spending. And that's consistently brought down inflation in the face of a very strong economy.

Now let's look at the effect of the Internet. It will be dramatic. It will squash inflation entirely out of the system. You'll have a deflation in the goods part of the system within a couple of years. The only reason you'll have nominal inflation at all is because of the service sector. This leads to a drop in interest rates, and extremely high valuations in stocks.

Q: *It doesn't sound too nice for earnings.*

A: People always say deflation will have a bad effect on corporate earnings. Certainly, some industries require a level of inflation to grease the wheels, make them profitable. It's also striking that the best, fastest-growing and most productive industries – the computer industry, the semiconductor industry, even the brokerage industry – have all been laboring in a deflationary environment. The price of a semiconductor has consistently been dropping. Ever since 1975, brokerage commissions have dropped at a very rapid rate. Yet both have prospered in a highly deflationary scenario. When you have a product to sell and its price continues to drop, people buy more. That elasticity benefits a lot of industries. So I'm not sure it will hurt profits. It may accelerate them.

Q: *How bullish are you?*

A: Extremely! After our little profit-taking episode this week, I believe the market will regain its momentum and close at 11,000 by the end of the year. I think it will go up to 20,000 by 2004.

Q: *Can it be true? You're more bullish than Abby Joseph Cohen.*

A: Sometimes I chide her when she loses the faith.

Q: *How do you arrive at your target?*

A: It's straightforward. I am assuming that the rate of inflation is going to go to zero. It's at 1.6% now, year over year. The CPI just released is up 0.1% both on the base and on the core. In terms of product, you have almost zero inflation now. The main inflation pressure is coming from the service industry. A number of factors, especially the Internet, will have downward pressure on pricing over the next three or four years so the nominal rate will get to zero. Historically, in the last five or six years, the real rate of return on the long bond has centered around 4%. Yes, it's been a little higher, it's been a little lower, but that is the central tendency. So it would be presumptive that at zero inflation, the long bond would yield 4%. Take that a step further, and say that the earnings yield of the S&P 500, which is the reciprocal of the P/E of the S&P 500, has traded for 15 years in a range between 50% and 95% of the long bond. The median relationship is about 75%. And let's assume that earnings of the S&P 500 grow at 8% a year, their long-term trend. So by 2004, you get $70 a share of earnings for the S&P 500. And if you assume the long bond is yielding 4%, and the earnings yield of the S&P will be 70% of 4%, that's 2.8%. And it translates into a 35 multiple. Put a 35 multiple on $70,

Alger's Picks

Company	3/23 Price	Comment
@Home (ATHM)	146	The leading company to put the Internet over cable television. Alger sees jump to $200.
Broadcast.com (BCST)	114 1/4	Distributes corporate communications on the `Net, like Victoria's Secret conference call.
Ivillage (IVIL)	75	Website for women has "everything from child-care to astrology."
Medtronic (MDT)	69 5/16	Straightening out the AVE acquisition and launching new defibrillator and stents.
Boston Scientific (BSX)	38 1/4	Jim Tobin, the Biogen whiz, is shaking up this stent manufacturer.
Amer Home Prod (AHP)	65 1/4	New products, including ulcer, sleep, and transplant treatments, could boost stock to 72.

extrapolate the same kind of gain for the Dow, assuming the Dow and S&P 500 move in lockstep, and the Dow doubles. It goes from 10,000 to 20,000. QED. You heard it here.

Q: *We've heard some similar forecasts recently. Where do you depart from most people?*
A: They've felt all along that we're at some kind of ceiling in terms of valuations. That there's a finite rule for how high valuations can go. Basically, you have to look at the competitive investment, which is fixed-income securities. Yields will go lower and lower, in my opinion, ultimately culminating in 4% or less. Okay, some people say it's now 5.5% and doesn't show any sign of dropping. But everybody is used to things staying the way they are, and not to big changes. They don't realize I'm saying this will happen over five years. And the fact is, this relationship between the S&P 500 and the long bond has been the same for 15 years. Finally, the S&P 500 will constantly be revised to include better and better, faster-growing companies. It will become a big-cap growth index. And you have this huge membership effect from index funds, which you didn't have in the old days.

Q: *Zero inflation seems like a pretty risky assumption. Oil prices are rising, Asia is recovering, commodity prices will edge higher.*
A: A lot of people believe inflation is endemic, and it's been aided by a drop in commodity prices, principally oil, and it will be higher by the end of the year. I'm assuming that inflation is moving downward. No. 1, the economy has grown 3% a year since Ronald Reagan was elected President. When he was elected, inflation was at 10% or thereabouts and has worked its way to 1.5%. This happened while the economy was very vigorous! There is no relationship between the strength of the economy and the level of inflation that can be demonstrated all the way back to 1980. Why people think there is, is a mystery to me. Second, Asia is turning around. Hmmm, it would be nice, but I don't know that it's happening. Certainly Korea, Malaysia and Thailand have turned around. Indonesia, maybe. Japan is a question mark. China? It's in a state of deceleration. If Japan is flat, and China falls off, then I am not sure Asia is turning around. Third, oil was at $12 a barrel in 1986, when the king of Saudi Arabia fired oil minister Yamani and decreed by fiat that oil would be $18 a barrel. So oil shot from $12 to $18. Then, it managed to work its way back down to $10 a barrel earlier this year. Now, OPEC has rattled its saber and oil is shooting back up again. But point to point, from 1986 to the present, the price of oil is down despite an incredibly strong and vigorous economy, despite a reduction in unemployment, and despite the fact that, with the exception of the last couple of years, Asia and the Third World have generally been developing very quickly. If oil were $40 a barrel, I'd be very concerned. At $15 and $16 a barrel, it's a dead-cat bounce. Yes, OPEC looks serious this time. The Saudis are sponsoring this new agreement, and Saudi Arabia was thought to be trying to get share away from the others. But who knows if an OPEC agreement will stick? They've never stuck in the past.

Q: *This incredibly narrow market suggests that the stocks you first made your name in – small-cap growth companies – will fare worse than in the past. Have your views transformed you into a big-cap growth investor?*
A: I am always misclassified! It started back in 1989, when our small-cap fund was the No. 1 fund in America. So everybody said, "Oh, you are a small-cap investor." Actually, the predominance of our money under management has always been either large-cap or all-cap. We are not wedded to any market cap. I don't really have a preference. I have never seen valuations of small-cap stocks as low as they are now – not by our models, or by anybody else's. Clearly this will be rationalized at some point.

> *"Some of these companies are put together just to sell out—investment-banking events, not real companies."*
>
> —David Alger

Having said that, I have a suspicion as to why small companies aren't doing better. That is because the Internet is creating the biggest revolution in American and even world business that has existed probably since the advent of the computer itself. The market may be saying that little companies will be demolished one after another by companies selling similar products on the World Wide Web. They will not be able to compete in the world of 2005. I am told that in California, this is called "being Amazoned." And the market may be saying, in its own subtle way, that if **Barnes & Noble** can be Amazoned, so, too, can any of these little companies that appear cheap now, but may not be around in five years because something-something-dot-com will take away their business. What's more, there are obviously structural reasons that make people fear the Fed will raise rates or we're heading into a recession, or simply that the market has had a long run. They want to be in liquid stocks. Large-cap mutual funds are now getting the lion's share of money. All this is conspiring to create a large-cap bull market and a small-cap bear market.

Q: *Successful as you've been at calling the market, people know you best as a stock-picker. Among other things, you're known for adroitly trading IPOs. What does a typical Alger stock look like?*
A: If they know us best for stockpicking, it's because we're beating our benchmarks. And though we do play IPOs, which will continue to have some hot sectors, we don't get any bigger allocation than anyone else. In a nutshell, I like companies that are growing very fast. I like them to have earnings so I can put a P/E on them. I like companies that are growing fast at the top line and the bottom line. I like high-unit-volume companies selling more goods and services at a high rate. I like them to have great high-value-added products, good management, sensible financial structures. We have a fairly high concentration in technology stocks as a result. It means we'd be reluctant to buy the cyclicals – aluminums, coppers, and the like – unless you saw evidence of accelerating earnings. Or to buy gold stocks, unless there's some specific story about a company discovering a new field and increasing production.

Occasionally, we'll also buy something we call a "life-cycle change" company, which has not been growing well but is seeing a sea change in its business, where a management or product change is spurring a high level of growth. You'd never see us in electric utilities unless there's a life-cycle change. Also, I don't like concept stocks that don't earn money.

Q: *Yet you're a fan of investing in the Web.*
A: My holdings there are the big exception to that rule. I first realized this was a major phenomenon a year ago. Before that, I thought it was a stock-market play. What changed my mind? I started to realize that many people I knew who weren't tech weenies or even especially computer-literate but were willing to adapt technology were

using the Internet for all sorts of purposes. A friend of ours, a very bright woman, notwithstanding the fact that she's an investment banker, uses it to buy groceries. A few years ago, my daughter was writing a term paper on politics for high school. I asked her, "How are you going to get the information for this?" She looked at me like I was insane. She said, "From the Web, *of course*." Her school had trouble figuring out what the citations should be. But she was accustomed to using the Web for all sorts of research. It never occurred to me the average person would use it. Then, along came things like Amazon.com and e-mail. E-mail became ubiquitous.

Q: *How do you sort through the Internet offerings? Should we worry about the speculative fever surrounding these stocks, as evidenced by eBay's humongous stock offering this week?*
A: Far from signifying the top of the market in these stocks, the potential success of the eBay offering is a testament to their importance. I'm an **eBay** shareholder. Any time you can raise capital at zero cost, it's wise. As to sorting through the offerings, it is very hard. There is no really good measure that you can use. Some have earnings, but most don't. They have very high valuations relative to sales. What we look at are companies that really have something special to bring to the Internet, which will let them grow and prosper and survive. A lot of Internet companies won't be around in five years. They'll be gobbled up, go by the wayside, eliminated by a competitor. There will be huge consolidation. Some of these companies are put together just to sell out. They are investment-banking events, not real companies. So we look for those we think will be category killers, that will dominate their space and become very large companies in the next five years.

Q: *For example?*
A: Look at a misunderstood company like **Amazon.com**. People say it can't sell books at a profit because its products have low margins. That really doesn't show a great deal of understanding of Amazon's business model. Amazon makes a very healthy profit at the gross profit margin line. What it perceives – correctly so – is that, just as the number of Internet customers is proliferating very rapidly, the number of Websites is also proliferating. If you are going to survive as a big player, you need an enormously large share of mind of those people clicking on to buy a book. Consequently, Amazon is spending an enormous amount on advertising and marketing. That's what keeps their earnings at zero. Not the fact that they can't sell a book profitably.

Q: *Still like it?*
A: Amazon went from 86 to 200 between mid-December and January 11. We sold a whole bunch at 200. The acceleration of stock was too steep. It came back 55% to the 90s, we bought it again, and then it went back up. We still own the stock. It's like riding a tiger: You hang on for dear life. You have to be there. This is not just a fad product like the CB-radio craze. It's unbelievably important and you have to really analyze which companies will be long-term survivors. And it will take a lot of capital and the willingness to finance a company for many years. **MCI** was a very similar company; it ran at a deficit for years.

> *"Medtronic does have earnings. This year, it will be \$1.75 a share, up 20% from last year."*
>
> –David Alger

Q: *You're also a fan of **@Home**, which is moving up after the deal between **Comcast** and **MediaOne**.*
A: It's a great deal. We still own a very large position in Comcast. We think the cable companies are the Internet providers of the future. The fact that suddenly Comcast will have this access to homes is just massively exciting.

Q: *What's the case for @Home?*
A: It's a truly interesting company with a unique place in this business. The problem with the Internet, as any user will tell you, is lack of bandwidth. It is too slow to retrieve. You can't get good, full-motion video. A guy sitting at home is frequently frustrated by the access time. This problem needs to be solved. One solution is to put the Internet over cable television, which is a much bigger band width, rather than through the phone line. @Home is the leading company to do that. It has deals with just about every cable company – TCI, Cox, Comcast, Cablevision. The only ones it's now lacking are Warner Communications and MediaOne, which of course is being taken over by Comcast. At the end of 1998, @Home had 300,000 subscribers hooked up to this system. It's rising sharply. They just announced the acquisition of Excite, a leading portal company. It's a content provider. This lets @Home offer not only the ability to hook up cable TV and get much faster Internet service, but also provide its own proprietary portal.

Q: *How much is it growing? What's the stock worth?*
A: Right now, @Home sells for about 138, having risen fairly sharply in the last couple of days. I would be perfectly comfortable seeing the stock at 200 in the next couple of years. I think it will have a million subscribers at yearend. Their market cap is \$17 billion, which is a very high valuation per subscriber. However, by the end of 2002, we expect them to have over eight million subscribers. Assuming @Home is at 200, it would have a market cap of about \$35 billion, or \$4,375 per subscriber. That's comparable to many cable TV companies. Another way to look at it is that, in 2002, we expect the combined @Home/Excite to generate revenues of \$2.2 billion, and earnings per share of around \$3. A valuation of 70 times earnings would put the stock at \$210. Please note that the company will still be growing at an extremely high rate at this point.

Q: *Another stock, please.*
A: **Broadcast.com**. It sells around 100. It has a slightly different business. It takes corporate communications and distributes them over the Internet. You may have seen the Victoria's Secret conference call. That was handled by Broadcast.com. It's probably the most effective way to disseminate corporate information across a large spectrum of people. The Internet really lends itself to conference calls, video conferencing, video display. That's what Broadcast.com handles. It has its own content provider. It's locking up content music, content sports. It's archiving video. The important thing to understand is right now, having full-motion video conferences doesn't work very well with the Internet because of the bandwidth problem. It will be solved in a variety of ways. One is the new Pentium chip. The second is the cable modem. And suddenly, the Internet will be the best way to distribute video products of any kind. They're locking up the corporate end of the market.

Q: *Do earnings matter in this case?*
A: Obviously, it will have great earnings within five years. This year Broadcast.com should have revenues of \$60 million. We anticipate revenues of \$500 million in 2003.

So the company could earn $100 million, or $2.60 per share, on the current-share base. Consequently, a doubling in the stock by the end of 2003 would be logical.

Q: *What other Internet stocks do you like?*
A: A recent IPO called **iVillage**, which has iVillage.com. It came public around 24. It is now selling just below 80 but traded as high as 100. This site is oriented toward women. Women constitute a very interesting population for the Internet. Initially, they were way behind in terms of Internet usage, but now they've caught up. Also, 70% of family purchases are made by women. iVillage.com really supplies a lot of informational content across a lot of different areas. Everything from child care to astrology, to relationships, to the kinds of things you would find in women's magazines. It's starting to branch out and become an e-commerce company. iBaby.com, which sells children's products, is owned by iVillage.com. They also have an alliance to start selling pet food and other pet items. They derive some benefits from Astrology.net. We think they'll develop one on health and beauty aids, and that they'll enter the fashion arena. iVillage is run by two women, and I think it's a very, very exciting company. You have got to believe that this is a revolution, and you want to be in on the front end of it. It has a market cap of $1.4 billion, which as Internet companies go is not very big. It's 30 times our revenue estimate, versus 70 times for **Yahoo** and 200 times for **eBay** on a commission-revenue basis. We think revenues will grow 50%-plus a year. So the valuation could double in two years. We think iBaby.com, which should do around $20 million in revenues this year, will grow 100%-plus a year.

Q: *Let's move on. Do you like any stocks that aren't Web-related?*
A: We just started buying **Medtronic**. The stock had some problems recently, because they acquired a company called Arterial Vascular Engineering that makes stents, which are small devices to hold blood vessels open after angioplasty and other procedures. It turned into a big mess. They didn't execute, missed their quarter and the stock came down a fair amount. But we see some good things happening. They're cutting plant capacity at AVE and refocusing the sales force. They're cutting an estimated $50 million of costs a year from AVE. In a few weeks, they should have a new stent to sell and a very important new one called S670 by year-end. They're also launching a new defibrillator by the end of their April quarter. Medtronic does have earnings. This year, it will be $1.75 a share, up 20% from last year. In the year 2000, we'll see earnings at $2. The stock should sell at 40 times that, or $80. Right now, the stock is at 68, which gives you a nice pop.

Q: *Next pick.*
A: **Boston Scientific** is another medical turnaround, another company in the stent business. It's been very messed up. Then they got a new CEO from Biogen, Jim Tobin. We have a tremendous amount of confidence in him. We owned Biogen for a number of years and made a great deal of money in it. Boston Scientific has always been the weak sister behind Medtronic and **Guidant**. It sells at a significant discount.

Q: *What changes is Tobin making?*
A: Well, first he is rationalizing the business. They have many, many different businesses, own lots of little products. Second, the company is highly leveraged and needs shoring up financially. It needs cutting off bad product lines, simplifying, cutting expenses. It has some good new stents that came out recently. We think those will make for good comparisons for the next three quarters. It has the wind at its back. From a corporate standpoint, this company is a mess. But Tobin is getting the house in order. We think earnings will grow pretty rapidly in the 25% range starting in '99. And Boston Scientific will have a multiple closer to Medtronic. So we see 35 times earnings of $1.25 in 2000, which puts the stock near 44. It's currently around 38.

Q: *Last pick, please.*
A: We bought **American Home Products** around 60. We think it's going up to around 75. There will be no multiple expansion, but we think earnings will start accelerating after a period of flatness. They have several exciting new products. One is called Enbrel, a rheumatoid arthritis treatment created by **Immunex**. They have 40% of operating profits and full marketing rights internationally. The next is Protonix for gastric ulcers. That should be approved in the late summer. We also expect summer approval of Sonata, which is for sleep disorders and could be a $300 million product. They also have an organ-transplant drug called Rapamune, which will be really big. It's farther out, in the fourth quarter of this year. This is a very strong pipeline. For the current year, earnings will be up just nine cents to $1.87 a share. Then it will really ramp up, to $2.20 in 2000 and $2.50-plus the following year. And a 33-35 multiple on earnings of $2.20 or so would be around 72, just under where we expect it to go.

Q: *Thank you very much.* ■

For Producer Use Only

Past performance is no guarantee of future results. Investment return and principal will fluctuate and the Fund's shares, when redeemed, may be worth more or less than their original cost. The S&P 500 is an unmanaged index considered to be representative of the stock market in general. The holdings mentioned in the reprint are subject to change and the individual stocks listed may no longer be owned by the Fund.

FRED ALGER MANAGEMENT, INC.

1 World Trade Center
Suite 9333
New York, New York 10048
(800) 223-3810

BAR30-B