Dotcom bubble crash

Real world case study: Dotcom bubble

In the late 1990s, a rare financial event unfolded. It was a time when internet-based companies, just by adding ".com" to their names, saw their stock prices soar, creating an illusion of endless opportunities. But, beneath all the optimism, things were more complicated. This story is about the rise and fall of that digital dream, where high hopes clashed with the harsh realities of the economy, leaving a lasting impact on how we see finance. The phenomenon that we are discussing is the Dotcom Bubble.

In this chapter, let's delve into the events leading up to the Dotcom Bubble, examining the factors, consequences, and lessons learned from one of the most infamous episodes in financial history.

What Is the Dotcom Bubble?

The Dotcom Bubble was an asset valuation bubble in the late 1990s. It caused a quick rise in equity valuations of the USA technology stocks. Investments in internet-based companies fueled this rise during the bull market from 1995 to 2000. During this period, the markets experienced exponential growth. However, in 2001, the bubble burst, impacting the economy significantly.

How Did the Dotcom Bubble Form?

In the early 1990s, the World Wide Web (www) was introduced, and the usage of computers increased in every household in the USA, making it a necessity. This gave rise to the internet and tech-based start-up companies.

In the late 1990s, the low interest rates drove attention towards speculative equity investments over bonds. Simultaneously, the rising popularity of innovative internet companies captivated a diverse range of investors, from retail to professionals, including venture capitalists. The Taxpayer Relief Act of 1997 further fueled this trend by lowering the top capital gains tax rate, motivating investors to pour money into the budding internet industry.

During this time, the investment banks seized opportunities and started making more money by facilitating IPOs for many tech companies. Enthusiastic investors didn't mind the fundamentals and eagerly invested in young Dotcom ventures, many yet to turn a profit. To find the next big success, venture capitalists freely invested in any company that ended with a ".com" in its name. FOMO (Fear Of Missing Out) on the digital rush led to an influx of funds, eventually inflating the untested internet technology industry into an overvalued bubble, which was ready to pop anytime.

This highly inflated bubble lasted for almost 2 years between 1998 and 2000. The period from 1995 to 1997 is called the pre-bubble period, during which several factors started to hype the industry.

The chart above shows the sudden spike in the NASDAQ Composite Index.

How Did the Dotcom Bubble Burst?

On March 10, 2000, the Nasdaq index touched 5,048, double the previous year. Several high-tech companies, including Dell and Cisco, initiated huge sell orders of their stocks at the market's peak. This act generated panic selling amongst investors. Within a few weeks, the US stock market witnessed a decline of 10%.

As investment capital dwindled, cash-strapped Dotcom companies started to face a grim reality. The companies that witnessed a huge spike in their market capitalisation saw their worth dropping. By the end of 2001, most of the publicly traded Dotcom companies had collapsed, which resulted in the evaporation of trillions of dollars in investment capital. This ultimately led to a market crash.

What Were the Reasons for the Dotcom Bubble?

- **Overvaluation of Dotcom companies**

The internet and tech companies that went public during the Dotcom period were overvalued. The companies that didn't have a business plan also saw their stock prices increase significantly. Investors and analysts didn't focus on the fundamental analysis, business plans and revenue-generating capabilities of these companies. As most of the important metrics were overlooked, the valuations of tech companies soared high.

- **Abundance of venture capital**

Certain venture capitalists and investors invested hugely in tech and internet startups, which resulted in the Dotcom bubble. Also, due to low interest rates, funding these companies was easy. This factor inflated the bubble even more.

- **Media frenzy**

Another reason for the formation of the Dotcom bubble was the motivation provided by the media companies. These companies encouraged investors to invest in high-risk tech and internet company stocks with expectations of high returns.

Impact of Dotcom Bubble Burst

The Dotcom bubble burst resulted in the stock market crash in 2000. The Nasdaq index, which had increased fivefold from 1995 to 2000, dropped from its peak of 5,048.62 on March 10, 2000, to 1,139.90 on October 4, 2002—a staggering 76.81% decline. By the end of 2001, numerous Dotcom stocks faced insolvency, including established tech giants like Cisco, Intel, and Oracle, which saw over 80% loss in share value. And the Nasdaq took almost 15 years to regain its peak on April 24, 2015.

Also, as per several analysts, the crash caused a mild recession. However, the recession was not as disastrous as the one that occurred in 2008 due to the implosion of the mortgage-backed securities market and the housing bubble.

As per the New York Times, about 48% of the companies involved in the Dotcom bubble survived the crash, though temporary damages were done. Some of the companies that survived the storm are Amazon, Oracle, IBM, Adobe Systems, etc., which are tech giants currently. The companies that didn’t weather the bubble crash are Boo.com, Pets.com, Northpoint Communications, etc.

Did the Dotcom Bubble Impact the Indian Market?

The Dotcom Bubble had a significant impact on the internet industry in India. During that period, there was an interest towards Dotcom companies in India. A few companies that experienced a sudden rise during the late 1990s that faced several challenges after the Dotcom bubble burst are Satyam Infoway, Rediff.com, IndiaWorld Communications, etc.

Measures To Avoid Another Bubble

Proper Due Diligence:

Before investing in any company, irrespective of the sector, it is crucial to carry out proper due diligence. Check the company's fundamentals and understand their business models and future prospects. Invest only if you find the details promising. If you overlook understanding the position of the company, it can lead to another bubble, which would burst eventually.

Removing "investment of expectation":

Investors should stop investing in companies that have yet to prove their sustainability and ability to generate cash flow. The investments made on the basis of unrealised potential expectations can lead to the emergence of a bubble through speculation.

Avoiding companies with a high beta coefficient:

During the Dotcom bubble period, most tech and internet company stocks posted high beta (greater than 1). This means that at the time of a market downturn, the downfall of these companies would be more than what the average market fall would be.

Important Takeaways

- The Dotcom bubble is a late 1990s asset valuation phenomenon that led to a surge in U.S. tech and internet company stock values.
- The bubble was triggered by factors like low interest rates, which inflated from 1998 to 2000, only to burst in 2001, causing a significant market crash.
- The overvaluation of Dotcom companies, abundant venture capital, and the media craze were key contributors to the formation of the Dotcom bubble