Towards Large Domain Name Portfolios

Alex Tajirian

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ABSTRACT

This paper focuses on domain names from the perspective of an investor. It first develops a taxonomy of the sources of return and then demonstrates that domain name portfolio effects favor ownership concentration. The impact of a paradigm shift in online advertising and the portfolio roles of country domain names are noted in the concluding remarks.

INTRODUCTION

The need to analyze portfolio holdings of domain names is on the rise. However, the lack of analytical models has, until now, hindered serious consideration of the issue.

Businesses as well as investors hold portfolios of domain names, albeit for different reasons. For a business, the objective is to hold a portfolio of domain names that maximizes shareholder value through capturing the various corporate roles of domain names,[1] while minimizing their traffic overlap. On the other hand, for an investor, a portfolio provides risk diversification for a given level of desired return. Thus, both types of domain name ownership/use favor portfolios.

Portfolio returns have two components: 1) the magnitude of various sources of return and 2) their interaction over time. I first develop a taxonomy of the sources of return and then outline the drivers of interaction.

SOURCES OF RETURN

There are two independent sources of return on investment created by a portfolio of domain names: buying under-priced domain names[2] and generating revenue from traffic monetization. The underlying value drivers for keyword-based domain names apply to parked as well as well as to content-free sites with only an "under construction" page. To

[1] See Alex Tajirian (2005), "Roles of Corporate Domain Names," DomainMart.

[2] For under-pricing of domain names, see Alex Tajirian (2005), "Domain Names Are Cheap!," DomainMart. For marketplace price efficiencies, see Alex Tajirian (2006), "Price Inefficiencies in Domain Name Markets: An Empirical Investigation," DomainMart.

bring portfolio risk diversification issues to the forefront, the paper focuses on returns from monetization.

There are five factors that influence the return on monetized domain names: (1) general economic conditions, (2) industry, (3) keyword specific, (4) website specific, and (5) random effects.

1. General Economic Conditions

The general conditions of the economy have a tremendous impact on all domain names. In general, a healthy economy has a positive effect on returns, while a slowing economy has the opposite impact. The health of the economy is manifested through search volumes and pay-per-click (PPC) rates – the current online advertising paradigm. Every thing else held constant, economic growth has a positive impact on rates and search volume, while a slow economy has the opposite effect.

Nevertheless, in a slow economy, click fraud may increase. However, its impact on returns depends on the mechanism to price PPCs. With a PPC price that accurately varies with traffic quality, click fraud would have minimal impact on returns.[3]

2. Industry

For any given set of general economic conditions, some sectors of the economy will outperform, while others will lag behind the aggregate market. Thus, PPC and search volume growth rates can have an additional industry-specific boost or experience a dampening effect on returns. Moreover, some industries are cyclical and highly time sensitive, such as retail sales; in such cases, Christmas-based domain names, for instance, will experience additional sources of variation in PPC and search volume performance over time.

3. Keyword Specific

There is empirical evidence on the divergence of PPC rates from their true value and across search engines. As of yet, there are no mechanisms to arbitrage such differences, and the convergence to true value may take time. Obviously, the difference between the market value of a click and the true willingness of an advertiser to pay for it, say, for the first search result position, can be positive or negative. Moreover, traffic quality pricing mechanisms may have an implementation time lag, another factor contributing to prolonged divergence.

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[3] Google and Yahoo have adopted different strategies to minimize the impact of fraud on the health of online advertising. For ads on their respective member-network sites, Google has developed its own proprietary pricing mechanism for the ads, called Smart Pricing, while Yahoo's strategy allows individual site owners direct control over their PPC bids. In the same spirit, Microsoft has developed Strider Typo-Patrol, a mechanism to detect domain name typo-squatters, inactive owners of domain names that are identical to highly-clicked names except for a typographical error (e.g., www.coko.com as compared to www.coke.com).

4. Website Specific

This factor impacts the performance of specific websites irrespective of their keyword composition or general economic and industry conditions. Its effect on returns is a function of the following variables:

a. The source of traffic to a particular website, as to whether it comes from type-ins (direct navigation), search engines, blogs, and whether it's domestic or international.

b. When a searcher lands on a page, the number of clicks on page ads depends on the "look and feel" of the site and the intent of the searcher.

c. Possible interruption of service due to the domain name owner's negligence, such as forgetting to renew the domain name's registration.

d. When the domain name owner receives monetization income that is not in the home currency, fluctuations in return due to exchange rate movements will be incurred.

e. The extension of the domain name – whether .com, .net, or country designation - impacts traffic volume, especially type-ins, and the click rate, as the extension signals the type of site content, which needs to be congruent with the searcher's intent.

5. Random Effects

These are random effects that cannot be predicted and that, on average and given their random nature, have no effect on the returns of a diversified portfolio of domain names. One such effect is interruption of service at the ISP level that is beyond the domain name owner's control.

PORTFOLIO EFFECTS

Portfolio risk reduction comes from two sources: controlling a large number of domain names (diversification) and/or domain names whose returns are negatively correlated (risk reduction). However, without adequate data on historical domain name or PPC returns, determining a critical portfolio size to reap the benefits of diversification becomes unfeasible.

Sources of Negatively Correlated Returns

The presence of negative returns does not necessarily indicate a systematic negative relationship between PPC rates and general economic conditions. One or more of the following may yield negatively correlated returns:

1. PPC rates can move in opposite directions as a result of the divergence between true and market prices, as noted earlier.

2. Although it is true that the major PPC market, the U.S., exerts dominance on other global monetization programs, there can be prolonged periods of superior monetization performance with international programs, where advertising rates are driven by domestic economic conditions. As online advertising markets in other countries expand, these programs will become more significant to domain name portfolio optimization.

3. Currently, most of the monetization service providers pay out monetization revenue in U.S. dollars. Thus, adverse fluctuations in exchange rates result in negative returns, other things held equal.

CONCLUDING REMARKS

1. There should be no effect on portfolio diversification when the online advertising paradigm shifts towards pay-per-action (PPA). The same diversification principles as those operating in a PPC environment will continue to apply.

2. International diversification through ownership of country domain names, if executed wisely, is a recommended portfolio strategy.

3. A prudent domain name protection strategy should not be ignored.[4]

4. Taking advantage of risk diversification leads to ownership concentration of domain names through large domain name portfolios, especially when opposing forces are absent.

[4] For an analytical framework for domain name protection, see Alex Tajirian (2005), "Domain Name Protection: A Risk-Analytic Framework," DomainMart.