Review of
"Domain Investing: What You can learn from the Stock Market"[1]

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Abstract

Below we demonstrate that the reviewed article's analogies between domain names and stocks are flawed, and thus that the resulting parallels are not illuminating.

Is the analysis valid?

As the title suggests, the objective of the article reviewed below is to draw similarities between stocks and domain names,[2] and then to use these similarities to suggest domain-name investment strategies. However, for such an approach to be fruitful, the analogy must be based on a valid one-to-one correspondence between the analogous elements. If the identified similarities are also applicable to other classes of assets, the implications become ambiguous.

We examine the arguments in the order they are made.

For a start, the title is misleading because the article compares assets, not markets. Comparing markets would involve issues such as exchange mechanisms, efficiency, transactions costs, and liquidity.

The first paragraph notes, "With a multitude of investment opportunities to choose from, speculating on domain names is a fairly recent occurrence."

> Although the statement is true, it is not clear whether speculation is being equated to investment, which are two distinct approaches to make money. Making money on domain names lends itself to fundamental analysis, and thus, financial valuation and investment techniques can and should be employed.

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[1] Tim Schumacher, Mara Miller, and Edie Abigail Dover, "Domain Investing: What You can learn from the Stock Market," Sedo.

[2] For issues regarding analogies between domain names and real estate, see Alex Tajirian, "Domain Name and Real Estate Analogy Is Slippery," DomainMart.

"Stocks provide dividends and the potential for capital growth. Similarly, domains provide revenue and growth potential. Domainers can earn revenue from domains through parking (similar to a stock′s dividends) and sell them for profit (similar to the way capital growth is expressed in the stock market)."

Investment in bonds and interest-bearing money market accounts, for example, also yields periodic income. Thus, earnings from parking are also similar to earnings of other classes of financial instruments. Moreover, an analogy can also be made between the cash flow components of domain names and bonds, given that bond investors earn periodic interest and can sell the bond at any time for a profit or loss.[3] As investment strategies in different financial assets vary, the article's cash flow analogy is not unique to stocks. Hence, adopting stock-specific investment strategies to domains becomes fatal. Furthermore, dividends and parking income are different in the following respects:

(a) Typically, divided payments are constant[4] unless they are announced as special distributions. On the other hand, parking revenue depends on the domain name's earnings for the period, and thus, has a large random component.
(b) There are typically severe market price penalties for missing a regular dividend. On the other hand, parking revenue fluctuations are expected and do not necessarily have a disciplining effect on the monetizer in terms of the threat of the investor allocating domains to a competitor when revenue drops.
(c) A large number of Fortune 500 companies, especially high tech, do not pay any dividends.[5] Thus, the periodic cash flow/revenue analogy fails. Nevertheless, there are situations, other than trademark-related, whereby the owner may be better off with a non-active site and forgo parking revenue.

"The main factors determining the value of a domain name are:

- (Future) resale value: Domains with the greatest resale value are those that are catchy, short, and have good advertising and branding potential. They should also have a common top-level domain (TLD) such as .COM. If a domain has all those characteristics, there′s a high likelihood that someone will buy a name at a premium in the future. However, the emphasis is really that this is future growth potential!"

Aside from the issue of the feasibility of quantifying the phrases "catchy" and "have good advertising and branding potential," domain name length is practically irrelevant and is not as significant as many practitioners

[3] During the holding period, if interest rates go down, the bond may be sold at a profit and vice versa.

[4] Constant either in terms of the amount or the payout ratio.

[5] There is a compelling tax argument that a firm's optimal dividend policy should be zero.

suggest.[6] Moreover, what does the article mean by "someone will buy a name at a premium in the future"? Premium over what? Is it over registration cost? If I buy a domain name with the suggested characteristics, will there be a high likelihood that I would be able to sell it at a premium? Nevertheless, even if a domain name has no growth potential but is expected to generate a solid constant parking revenue, it will also have a high value. Thus, growth per se is irrelevant in determining future prices; it is unexpected growth that drives additional value.[7]

- "(Current) Traffic: The quantity and quality of traffic influences the value of a domain."

  Current traffic is not a factor in determining price. The real factor is expected future cash flows, of which the resale value is only one component. Yet the article ignores the intermediate parking revenue stream. Nevertheless, current traffic may or may not be a good predictor of future parking revenue, not only because of idiosyncratic risk factors but also because revenue depends on who is doing the monetization and for how long, and on whether the domain name is appropriate for parking versus, say, leasing.[8]

"If you look at the stock market, two major forces also drive the valuation of a stock:

- (Future) growth: A company which will be able to grow fast (and make profits in the future) is valued higher than a low-growth company."

  A company that is able to grow fast and generate future profit is not necessarily valued higher than a low-growth company. In fact the growth rate can be zero and still have a higher value than a very high-profit-growth company. Compare, for example, the market value of a utility company with that of a high-growth start-up.

- "(Current) profits/EPS: A company which is more profitable is valued higher than a low-profit company."

  (a) As with current domain name traffic, as noted above, current EPS is not a force driving the value of a company.
  (b) It is a well-known fact that EPS can be artificially inflated. Thus, it is not necessarily a good measure of value or performance.

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[6] See Alex Tajirian, "Length of Domain Name Is Irrelevant!," DomainMart.

[7] See Alex Tajirian, "Valuing Domain Names: Methodology," DomainMart.

[8] For the determinants of parking versus leasing, see Alex Tajirian, "Making Sense of Domain Name Appraisals: The B/T Ratio," DomainMart, p 2.

(c) The article points out that for typo domains "the growth is limited." But, if the cost-per-click (CPC) and search volume for the non-typo domain key word have high growth potential, everything else being equal, wouldn't the associated typo domain name have growth potential too?

"Takeover Targets (e.g. Chrysler) - Stocks that have both low growth and profits. In the domain world, these are called Junk Domains (e.g. myjunkdomain.net). Junk domains earn lower parking revenue and do not have much value in an aftermarket."

It is not obvious why companies with "both low growth and profits" are takeover targets, as defined by the article. Using their domain name analogy, would have they classified, for example, Joost.com as junk few years ago? Moreover, with junk domain names as "Takeover Targets," why not invest in junk domains and reap the benefits of acquisition premiums?

The article goes on to classify games.com as a "star" domain (with both high growth rates and earnings) and vodka.com as a "growth" domain (rapid price growth with little profit). It is not clear how they arrive at the classifications, especially when there are no market prices for vodka.com.

"Purchasing growth stocks can certainly pose a risk with their high growth potential and low immediate profits, however many are rewarding in the long run."

US Treasury bonds face risk too, namely inflation risk, without having any cash flow growth potential. However, relatively efficient markets in the US reward investors for assuming risk.[9] What indication do we have that domain name markets will, on average, reward risk bearing? In fact, statistical studies show that domain name markets are inefficient, and thus, provide unfair reward.[10]

"As familiarity with the market increases, domain investors are not just investing in .COM domains, but have experienced success with branching out and adding an array of generic top level domains (gTLDs) such as .INFO, .NET, and .BIZ. Also included in the selection may be country code top-level domains (ccTLDs) including .US, .CO.UK, .DE and .TV. Even sponsored top level domains (sTLds) such as .MOBI are included to diversify and internationalize domain portfolios."

It is true that investors are buying other than .com domains and that such an acquisition strategy is rational. However, the idea that such purchases "are included to diversify and internationalize domain portfolios" is not necessarily correct. If the domain names in a portfolio, irrespective of their extensions, generate parking revenue from, say, only ads of US companies, diversification

[9] They also don't suggest that markets compensate only for systematic risk, not volatility.

[10] See, for example, Alex Tajirian, "Price Inefficiencies in Domain Name Markets: An Empirical Investigation," DomainMart.

> across extensions is equivalent to increasing the size of the portfolio and does not provide unique benefits. For parked domains, diversification across extensions is valuable when advertising is related to ad performance of other countries and when there is foreign exchange risk associated with the currency of revenue payments.[11]

The final recommendation in the article is to "Buy low, sell high!"

> First, this recommendation is not fully compatible with a diversification approach to domain investing, as diversification works irrespective of the investor's ability to identify lows and highs.[12] Moreover, there is strong empirical evidence that stock picking in US markets yields, on average, a lower return than a buy and hold strategy.

Concluding Remarks

We provided evidence that the reviewed article demonstrates a lack of understanding of basic stock valuation models and a lack of understanding of diversification drivers. Thus, any of the article's implied domain-name investment recommendations are dubious.

One can only hope that Sedo's domain name appraisal methodology is not based on financial valuation, and that the authors are not involved in performing such appraisals.■

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[11] For a portfolio approach to domain name investing, see Alex Tajirian, "Toward Large Domain Name Portfolios," DomainMart.

[12] See Alex Tajirian, "Domain-Name Acquisition Strategy & Valuation Drivers," DomainMart.