Bears on the prowl!

The bears are on the prowl. They are as right in this market as the bulls were in 1999. To borrow a phrase from John Kenneth Galbraith:

"Much discussion of money involves a heavy overlay of priestly incantation. Some of this is deliberate. Those who talk of money and teach about it and make their living by it gain prestige, esteem and pecuniary return, as does a doctor or a witch doctor, from cultivating the belief that they are in a privileged association with the occult -- that they have insights that are not available to the ordinary person. Though professionally rewarding and on occasion personally profitable, this too is a well established form of fraud. There is nothing about money that cannot de understood by the person of reasonable curiosity, diligence and intelligence.... The study of money, above all other fields in economics, is the one in which complexity is used to disguise the truth, not to reveal it. Most things in life -- automobiles, mistresses, cancer -- are important principally to those who have them. Money, in contrast, is equally important to those who have it and to those who don't. Both, accordingly, have a concern for understanding it. Both should proceed in the full confidence that they can."

From *Money, Whence it Came, Where it Went.*

This applies to securities as much as it applies to money!

There is a bear who has been trying to wreak havoc on the NPI board at the Motley Fool. What follows are two of my replies to the bear.

What's Wrong with the Gorilla Game?

Let's face it, a lot of us Gorilla Gamers were wiped out when the stock market bubble burst. Is there something inherently wrong with the Gorilla Game or are the causes of our troubles elsewhere? Some tend to think that the Gorilla Game is just a passing fad like the nifty fifty. I don't believe that. Yet playing the Game did lead to a bad conclusion. Why?

Let's take a look at the genesis of the Game. Geoffrey Moore is not an investment adviser. At least, he wasn't one when he co-authored the book. Back then, Geoffrey Moore was a very successful marketing consultant to the high tech industry mainly in Silicon Valley. Moore authored two most excellent books on high tech marketing: *Crossing the Chasm* and *Inside the Tornado*. Just from the titles we can deduce that they are the basis of much of the Game. Since Moore didn't have the expertise in finance and investing, he sought outside help. Not only did Moore join up with two investment specialists, Paul Johnson and Tom Kippola, to co-author the book but he sought help in the field of finance from Michael Mauboussin at Columbia. Anyone who has read the works of Mauboussin where he tries to justify the financing of the dot.com bubble knows, in hindsight at least, that Cashflow.com is a lot of horse manure. Cashflow.com set out to "prove" that you don't need earnings, just a positive cash flow.

I believe that the best designs are the product of a single mind that understands the entirety of the subject matter. I believe that the Gorilla Game is a very good approach to high tech investing but it lacks a certain wholeness in that it does not address investing as a subject. The Gorilla Game is the chapter on high tech in the book on investing. There are many investing subjects not addressed by the Game, for example, capital preservation and diversification outside technology.

I realize that comparisons are odious but the one that I am about to make goes to the heart of the matter. Some posters have said that the "nifty fifty" was a bad idea and they are comparing the Gorilla Game to the nifty fifty. In hindsight it is an easy evaluation to make. But Warren Buffett saw the problems of the nifty fifty at the time they were happening and he exited the market:

In 1969, Buffett decided to end the investment partnership. He found the market highly speculative and worthwhile values increasingly scarce. During the *late 1960s, the stock market was dominated by highly priced growth stocks. The "nifty fifty" were on the tip of every investor's tongue. Stocks like Avon, IBM, Polaroid, and Xerox were trading at fifty to one hundred times earnings. Buffett mailed a letter to his partners confessing that he was out of step with the current market environment. "On one point, however, I am clear." he said. "I will not abandon a previous approach whose logic I understand, although I find it difficult to apply, even though it may mean foregoing large and apparently easy profits, to embrace an approach which I don't fully understand, have not practiced successfully and which possibly could lead to substantial permanent loss of capital."*

From *The Warren Buffett Way* by Robert G. Hagstrom.

The problem with the Gorilla Game is that it has no emergency exit strategy. But the previous statement has to be qualified. The Gorilla Game was written for the nineties, a decade of prosperity and a decade during which the stock market rose at a clip quite a bit faster than its average historic performance. The Gorilla Game never contemplated the possibility of the bubble bursting. But then, neither did most of us.

I'm glad to report that the NPI board is healthy! Unlike Mauboussin, we know that earnings matter, we know that valuations matter. Some of us paid a steep price for the lesson but the lesson has been well learned. And having learned the lesson, I believe we can be less fanatical in the application of the Gorilla Game mandates. There is a higher authority out there, the art and science of prudent investing!

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The Nifty Fifty

People seemed genuinely annoyed by my Nifty Fifty comparison. I stand by it. The N50 could do no wrong. Buy these 50 stocks and valuation did not matter. Same with gorillas. Buy them and hold them. Valuation does not matter. The N50 will always be undervalued, gorillas are always undervalued. Same difference, different era.

Even though there appears to be great similarity between the buy and hold mentality behind the nifty fifty and the Gorilla Game, they are based on very different assumptions. The nifty fifty was based on wishful thinking that was self fulfilled for a while. If everyone believes that a certain list of stocks will always go up and never down then they will buy and hold and accumulate these stocks. As there are no sellers in this scenario, the price cannot drop. Then some exogenous factor creeps in and someone is forced to sell, the magic spell is broken, the house of cards collapses and the emperor has no clothes. [How is that for a collage of metaphors?]

As I said in my earlier post, the Gorilla Game is based on the reality of high tech marketing. The Gorilla Game is the direct descendant of *Crossing the Chasm* and *Inside the Tornado*, two books about high tech marketing. The Technology Adoption Life Cycle (TALC) does not exist in a vacuum. It is amply supported by the economic law of increasing returns, path dependence and other work being done at the Santa Fe Institute. That aspect of the Gorilla Game is rock solid but that does not mean that it is easy to apply. Before you can rank a company as a gorilla a certain number of issues have to be resolved. You have to be able to answer certain technical and marketing questions such as:

- Does the company own an open architecture that causes high switching costs?

If you don't have a good understanding of the technology involved, you cannot answer that question.

- Has the product advanced far enough in the Technology Adoption Life Cycle to hook the herd, I mean, the pragmatic majority? In other words, has path dependence set in?

If you don't have a good understanding of markets and sales figures, you have a lot of difficulty answering that question.

The Gorilla Game has not suspended the economic laws of the stock market. Even if Microsoft, the company, is a gorilla, MSFT, the stock, is a commodity. Stocks don't respond to the law of increasing returns but to the law of decreasing returns. The price of a stock is set solely by supply and demand. That is why the Nifty Fifty were nifty until they stopped being nifty. There was an overabundance of money flowing into 50 stocks and their price, by necessity, became inflated. What the authors of the Gorilla Game claim is that the stock of gorilla companies tends to be inefficiently priced -- underpriced -- because most people don't understand or don't realize the real power of a gorilla company. Under normal stock market conditions -- non bubble conditions -- the stock of gorilla companies will tend to be undervalued. As we have recently experienced, when a bubble sets in, everything is overpriced by the feeding frenzy. In the buying frenzy people no longer distinguish gorillas from chimps, monkeys, kings, princes, serfs or fish. They buy everything that is touted. Don't blame the Gorilla Game for the bubble, that is the wrong perspective. The bubble is the outcome of many things starting with the Reagan supply side revolution which put a lot of money in the pockets of American consumers, the death of the Evil Empire, fiber optics, the WWW, Y2K, Moore's law, NAFTA. Two of the advocates that are receiving the blame for the bubble are GG (George Gilder) and GG (the Gorilla Game). Of course they were leading actors in the drama but they were not the producers of the play.

To answer your question:

Does that mean that one should not attempt to apply GG standards to companies. Of course not. The ideas are fine. I am just doubting the finding of any new gorillas in this market at reasonable valuations. Does that mean one should stop looking, NO. But looking for the next PNRA is far more likley (sic) to be successful IMO.

The Gorilla Game will start working again when the forces of the bubble have dissipated and the market returns to its normal state of affairs PROVIDED that not too many people read the book and realize that gorillas are being sold for a bargain. One of the more interesting pieces of work, at least in my estimation, is being done at the Santa Fe Institute by Stuart Kauffman on fitness landscapes. Very broadly speaking, we are all working to improve our situation but this work also changes the fitness landscape on which we live. As the fitness landscape changes, the rules that worked yesterday might or might not work today. In a word, **co-evolution.** If enough people catch on to the fact that the stock of gorilla companies tends to be undervalued then the Gorilla Game will be toast because the market will improve its pricing of the stocks of gorillas. Since the stock market deals in commodities -- securities -- it is ruled by the law of diminishing returns. Our stock market gains will return to the norm.

The major cause of pricing inefficiency is lack of correct information. The whole purpose of the web is to put the right information in the hands of the people that need it at the moment they need it. The web could destroy the Gorilla Game.

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