Gilder Stock Picking

GG does not know how to pick stocks -- the death of a lot of Page 8 companies proves it. The question is, why is he such a lousy stock picker? Some people have accused him of being a fraud and a shyster. They are wrong. George Gilder is a most honorable man. He knows about paradigms but he does not know about stock picking. Let me explain why.

Gilder wrote: *The science on which a technology is based, however, can be studied and such study offers access to the key fundamentals with a calculable impact on the future.*

Then he contradicts himself: *Being unique an innovation represents uninsurable risk.*

The first statement is wrong and the second one right. If you cannot calculate the risk of an innovation you cannot make the required risk/reward calculation which is the basis of sound investing.

Why is the first statement wrong? Because it relies on Newtonian certainty, the basis of the classical economic model. You study gravity and you can tell what will happen if you drop a stone: it will fall to the ground. You have predicted the future. In the realm of economics things are not so predictable. Gilder has a lot to learn from Brian Arthur and the people at the Santa Fe Institute. Path Dependence and Increasing Returns are the main reasons why the best technology does not necessarily win. From an interview with Dominic Gates back in May 1998:

Gates: *And path dependence?*

Arthur: *Imagine there are increasing returns in the market with several products, all competing: Microsoft Money versus Quicken, or ActiveX versus Java. They're competing and then one of them gets ahead. If there's enough increasing returns there, as any one of them got ahead it would get further advantage.*

When you have increasing returns, at the outset markets are unstable and lurch back and forth according to different small events, and then lock in to one of many possible outcomes. What locks in is a function of what happened in history. The outcome in increasing returns markets depends on small events along the way. The shorthand for that is "path dependence." Meaning that small events along the *way decide the outcome.*

The U.S. presidential primaries are very path dependent. Depending on who gets ahead, there are increasing returns. Candidates who look more presidential attract more money; if they have more money, they get more television time; with more television time, they're more likely to look like a presidential prospect. The outcome is decided by the pathway the whole process has taken through Iowa and New Hampshire.

Gates: *Once you start down one path, whatever it is, it's hard to go back.*

Arthur: *Yes. It grooves-in a path. If rain falls on top of a sandy mountain, pretty soon it'll groove a pathway down the mountain and small events at the start will determine the topography and what rivers eventually form. It's important to note that the outcome is not completely determined by what's best. The outcome is partly determined by who gains what advantage when.*

For additional free reading material from Brian Arthur visit his Selected Papers.

Gilder wrote: *There is no alternative to actually understanding the companies and what they do, and the political and economic environment in which they do it.*

Yes, there is. Let Main Street tell you what stocks to invest in. That is the message from **The Gorilla Game:** An Investor's Guide to Picking Winners in High Technology by Geoffrey Moore. Moore's specialty is high tech marketing. He explains how high tech products are adopted by the market using the TALC model, that is, Technology Adoption Life Cycle. Gilder is one of the very early adopters, a technology enthusiast. He "buys" the product before path dependence has set in. According to Moore, path dependence is decided during "The Tornado," when the pragmatists massively adopt the technology. The Tornado is the time to buy hardware companies, not sooner.

Of course, if you get in as early as Gilder suggests and you happen to luck out, the rewards will be gargantuan. Unfortunately, the risk involved is just as great. This is the kind of risk/reward ratio that a venture capitalist finds acceptable. For us, individual investors, it is not acceptable. You don't hear the venture capitalists complaining but you sure hear a lot of whining on the GTF by people who took on way too much risk without knowing what they were doing. We are now at an unfortunate turn of events. Not too long ago Gilder's picks and the technology bubble happened to coincide. Back then you could throw darts at a technology list and make a fortune. During the bubble there were practically no losers. This coincidence turned out to be very unfortunate. A lot of people, including Gilder himself, were convinced that Gilder knew how to pick stocks. The bursting of the bubble and the demise of a lot of page 8 companies is proof to the contrary.

Gilder wrote: *Despite my interest in economics, I am afraid I seriously misjudged the economic environment and thus drastically miscalculated the impact of debt on telecosm companies.*

Yes, most people did. But sound stock picking techniques would have kept a lot of GTR subscribers out of trouble.

Sound stock picking in high tech should be guided by modern economic theory, not by the classical economic theory which was modeled on the exact sciences, on Newtonian certainty. Classical economic theory only recognizes the law of diminishing returns because that leads to calculable equilibrium. The law of increasing returns, the stuff of modern economic theory, says that there is no predetermined equilibrium. Path dependence will pick one of the many possible equilibrium points. Just as we now recognize (at least some of us :-) that Keynesian economics was wrong and that supply side economics is right, Gilder needs to move from classic economic theory to modern economic theory, from diminishing returns, equilibrium and certainty to increasing returns, instability and path dependence.

I think it's time for Gilder to study with Brian Arthur.

Denny
"Demand creates queues. Supply gets rid of them."
Software Times