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Gorilla Gaming in Bear Markets

Matt Tompkins, editor of the Rule The World Newsletter, asked an interesting question on the New Paradigm Investing board at TMF:

What happens to a tornado market when the economy falls off a cliff and everyone stops spending money? Since we've never encountered a market environment like the one today, there is no precedence on which to base an opinion. This got me thinking about the nature of a tornado itself (Mind you, I haven't read Inside the Tornado so please correct any errors I make).

A marketing "Tornado" is just a metaphor. This metaphor was used by Geoffrey Moore, initially in Inside the Tornado, to call attention to a certain stage in the marketing of high tech products. Next, he used it in The Gorilla Game as the signal to start buying the stock of certain high tech companies. In Living on the Fault Line, he uses it as a signal to change management styles to allow the corporation to make the most of a marketing event. Since Moore is not a scientists but a marketing consultant, he does not enter into the underlying reasons why Gorilla Gaming works, he limits himself to explain the practical aspects of the game.

Marketing is a practical application (or consequence) of economics, the science. Brian Arthur at the Santa Fe Institute has crystallized the thinking about the so called "knowledge" markets. The older bulk manufacturing markets can be described, profitably, with the methods taken from classical economics, with concepts like diminishing returns and negative feedback. The more recent "knowledge" markets cannot because they respond to increasing returns and positive feedback. Arthur covers this in a short paper, Increasing Returns and the New World of Business, that appeared in Harvard Business Review, July-Aug., 1996.

Basically what Arthur is saying is that diminishing returns and negative feedback bring economic systems into stable equilibrium while increasing returns and positive feedback do not. Mathematically speaking, positive feedback creates several possible states of equilibrium and there is no possibility of forecasting which one will prevail. Arthur uses a cone standing on its apex as an example: we know it will fall over because it is not in a state of equilibrium but we don't know, and have no way of ascertaining a priori, in which direction the cone will tumble. Moore, being a practitioner of the practical art of marketing, hides all the complexity of the theory in a "black box" which he calls the "tornado." According to Moore, several competitors enter the black box -- the tornado -- and by a chaotic process whose outcome we cannot predict, a winner emerges. See how useful the "black box" metaphor is? The black box, in effect says, don't bother trying to figure out what happens inside, take the result on faith, it has been certified by people with a higher level of knowledge that you don't have and that you don't need to do your job.

Once we understand that the tornado is just an abstraction of the complex processes at work in marketing in normal times, we can proceed to answer Matt's question. In my opinion, tornado or no tornado, in knowledge based product categories that have "Open Proprietary Architecture with High Switching Costs," the market will select a winner because that is dictated by underlying economic theory. If this selection does not happen, then it's not the economic theory that stopped working but the product category never had the conditions to create a real gorilla. In a bear market, or rather, in a slowing economy, the chances for tornado formation are less than in a vigorous market. The lack of tornados does hinder our ability to pick the winners but I don't think it really hinders the formation of gorillas, it just slows the process down.

From the standpoint of the Gorilla Gamer, the importance of the tornado is as a buying signal. When a bear market is in full force, when P/E ratios are getting themselves compressed, it does not make much sense to invest money in the market. The prudent course of action is to wait for a bottom before putting more cash at risk. For these reasons, the lack of tornados in slowing economic markets should not be a worry for the Gorilla Gamer since this is a time for wait and see anyway.

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