Posted to the Gilder forum - December 29, 2000

GTR for Dummies!

There has been so much battling between the pro and the anti Gilder forces around here lately that I decided to take a new look at the issue. Just this weekend I reread "Grow Rich on the Technical Revolution" which seems to be at the center of the controversy. Richard Vigilante strongly defends the piece while a lot of the GTR subscribers say it's a lot of bull shit.

I am convinced that all of us can take advantage of the GTR and of GG's forecasting prowess. The trouble with the debate so far has been that the winners have told the losers to shape up or ship out and the losers have told the winners that GG is, at best, a charlatan and, at worst, a crook. I think most will agree that this is NOT the way to reach agreement on anything.

I think that it is fair to say that GG has several audiences, the technically savvy and the technically naive on the one hand and the financially savvy and the financially naive on the other. That makes four different kinds of readers:

Readers		**Technically**	
		Savvy	Naive
Financially	Savvy	A	B
	Naive	C	D

Up to now, all of us have tried to shoehorn everyone else into our particular position and clearly this does not work. I think I have hit on a way that all four groups can benefit from GG and the GTR.

Before getting into the method proper, I would like to refresh some definitions or rules of the game. First of all, Gilder's paradigm is a long term process; the evolution of the Telecosm will happen over many years, probably decades. As Harry Dent in The Roaring 2000s and Geoffrey Moore in his books have stated, the life of the Telecosm is not uniform over its lifetime. The better explanation is by Moore and his "Technology Adoption Life Cycle (TALC)." Also, as Clayton M. Christensen has pointed out in The Innovator's Dilemma disruptive technologies take over from older established technologies. What all this means for the investor is that there will be some changes in the relative importance and financial return of the various companies and products over the life time of the Telecosm. For example, cable and DSL are presumed to be short term alternatives to fiber to the home or fiber to the curb. Also, TDMA was an early cellular standard that we know is being superseded by CDMA. NAS is overtaking SAN in storage. There are also exogenous factors affecting the price of the shares of Telecosmic companies, for example, money supply, market sentiment, elections, time of the year, wars, commodity prices and many more. From the above we can determine that the Telecosm is a long term affair with mid term changes in the specifics and short term fluctuations in the price of the shares. The short term workings of the stock market are excluded from this discussion. That subject is the proper terrain of Technical Analysis, speculators and traders. Simply stated, Gilder's paradigm is incapable of dealing with these short term exogenous factors and they are considered as "noise" in the long term evolution of the Telecosm. Noise, as used here, is not a term of derision but one I'm borrowing from the communications industry where they talk about the "noise to signal" ratio and where they spend a lot of time and effort getting rid of the noise to better appreciate the signal. For this reason, short term market fluctuations are ignored or filtered out of the decision making process outlined here. If you cannot live with that, you will have to use Technical Analysis as part of your buy, sell, hold decisions in the full knowledge that the Telecosmic paradigm does not deal with it.

We can now define Long Term Buy and Hold (LTBH) as it is used here: You buy the stock of Telecosmic companies for the lifetime of the Telecosm or the duration of your personal investment horizon, whichever is shorter, and do not sell them unless they are "disrupted" or superseded by other Telecosmic companies. Both the long term vision and the middle term variations are the proper subjects of the GTR. Short term stock market fluctuations are ignored with one exception, you can use Technical Analysis to time the purchase of the shares that you have decided to include in your Telecosmic portfolio.

A word about personal investment horizons. We all know the day we entered the stock market. For all practical purposes that is today because there is nothing we can do about the past, we can just learn from it. But most, if not all of us, have plans for the future. Study, get a job, get married, buy a house, have kids, send them to school, buy a summer cottage, spend more time (and money) on hobbies, retire. Each of these events probably requires that we spend an out-of-the-ordinary amount of money either as a lump sum or as installments over a certain period of time. Our spending pattern over our whole life will look like a saw blade with big teeth: the body of the blade is our routine spending and the teeth are the special events. To make sure that the blade does not break on account of the exogenous stock market movements which are ignored by the Gilder paradigm, you have to bulk up the blade a bit. This extra money, which you plan to never use, is what you will leave to friends and family the day you die. Most likely, the blade will be thin at the start of your life (unless you inherit a lot of money), it will grow as you increase your earning power at mid life and it can decline as you get older because you have fewer obligations to your children and a reduced capacity and inclination for doing expensive things. Most of this most of you know, if not explicitly, implicitly. The point that I want to stress is the safety factor that is built into this model and which allows you to "comfortably" ignore exogenous market fluctuations. As far as I am concerned (and this is not an original idea of mine but a concurrence with a great majority of successful investors), there is no way to consistently and profitably time the market. Therefore, we need a different mechanism to deal with it. In my case, it is an ample and sufficient reserve to weather the downturns without being forced to sell shares at fire sale prices. To calculate this reserve, estimate how much net money you have to take out of your portfolio in the case of a severe downturn that lasts a reasonable time, say two or three years.

I am sure that some people will not agree with the above. I would suggest that for them to continue reading might be a waste of time because all that follows is premised on the above.

Sorry, one more detour before we get to the main subject. What's wrong with the GTR's marketing piece, "Grow Rich on the Technology Revolution?" Basically that it is useless as a guide to investing because it tells you nothing useful about investing. All it does is to sell the GTR, which is fine as far as it goes, but it does not help the novice to husband his hard earned money. The piece was written by at least two people. The first page was written by George Gilder either for this piece or it was picked up from older Gilder writings by the editor of "Grow Rich..." How do I know? It's pure GilderSpeak! "...you are inundated weekly by an avalanche of stock-picking nonsense, touting unverifiable figures, fear mongering, and braggadocio after the fact." The rest of the piece was written by someone who definitively does not understand either investing or communication. For example: "By testing the Gilder Paradigm against the facts, the numbers and the results, George has been able to plot the vectors of advance that are the basis for his predictions." Horse manure! As I have said elsewhere:

I wonder how many of us realize why GG is so good at seeing the technological future. I have read a lot of futurists. Most of them tell you about the past and then extrapolate into the future. Their mistake is to assume that the future is an extension of the past. This is the error of Marx and the error of Malthus. GG does it different. He seeks two variables that qualify the age:

- The abundance, and
- The scarcity

Once he has found these two variables, he builds a future based on their logical devolution. GG does not extrapolate the past, he builds a brand new future.

George Gilder is creating a future in his mind. There are no "facts, numbers and results" against which to test this brand new future. As George has said about entrepreneurs, "It takes a leap of faith." Problem is, Forbes' marketing department does not have faith, they have MBAs and other expertise that is useful for analyzing case studies but not for predicting the future.

"Grow Rich..." is full of double talk: "A comprehensive strategy should include balance between risk and reward with asset allocation diversified among various assets types, i.e., equities, debt securities, real estate, etc." First of all, many modern writers (Markman, Siegel) disagree with this idea which is a leftover from Modern Portfolio Theory. If it were true, how much in bonds? Might as well say it: "Go learn about investing and then come back to the GTR." But, this frankness would lose the sale, wouldn't it? I love the close: "**OR you call a**

professional for consultation." This is the final admission that the GTR is useless as an investing news letter if you are not a professional financial type.

Enough bashing. Let's get to the meat of it. How to use the GTR as an investing guide.

You make money in the market by correctly predicting the future but, as Mark Twain said: "It is very difficult to make predictions, specially about the future!"

The past can be perfectly known but the future not. What do future prices depend on? Short term, the mood of the market, the collective mood of all investors and speculators. Long term, earnings, earnings and earnings. There are two schools of thought about price movements. The random walk school says that prices move at random, that a computer running a random number generator will produce a price chart that looks exactly like a price chart generated by the market. If this were true, you cannot beat the market. The efficient market school says that all that can be known about every company is known and that it is already built into the current price. Again, if this were true, then there is no way to beat the market.

A few people like Warren Buffett, Peter Lynch and Louis Navellier, for example, beat the market over time while most funds underperform the market. Of the three I mentioned, Navellier comes closest to using a mathematical formula. He uses a proprietary version of Modern Portfolio Theory (MPT) to decide what to invest in. I don't know exactly how he does it, but here is my take. He has a computer program that every week tests all ten thousand or so stocks that are traded in North America. The stocks are assigned a Risk/Reward ratio based on MPT (alpha, beta, standard deviation, etc.). The top 500 stocks become his "Buy-List" from which he choses what to include in his model portfolios. He does not say how this is done. Navellier uses a variety of "screens" (earnings, earnings surprises, analysts raising estimates, various growth rates, etc.) to do the final selection. These screens are not static, Navellier does quarterly back testing of "What Works on Wall Street." Based on these results, he juggles his screens and his selection method. He has been at it for twenty years and has been successful. Buffett and Lynch don't use anything nearly as complicated and I believe they outperform Navellier (this is a guess). If you want to study MPT, the book to read is Modern Portfolio Theory and Investment Analysis by Edwin J. Elton and Martin

J. Gruber. It is chuck full of formulas and it is an excellent cure for insomnia!

Peter Lynch and Warren Buffett use a lot less mathematics. They try to understand the businesses in a more conventional way. Lynch (One Up on Wall Street) does a kind of personal market research by eating the food, sleeping in the beds and generally using the products. If he likes what he sees then he starts to look at financials and talks to management. Buffett (The Warren Buffett Way by Robert G. Hagstrom) relies more on fair value calculated on the basis of discounted cash flows. Buffett tries to buy companies he likes if he can get them at a discount to the "fair value." Although it is seldom mentioned, Warren Buffett has discovered that it is a very good strategy to use other people's money if you can get it at a discount. This is the reason why his portfolio has so many insurance companies, savings and load associations and the Blue Chip Stamps company which provides trading stamps for supermarkets and gas stations. All these businesses create a "float," a pool of money, in the case of insurance to pay off claims and in the case of Blue Chip Stamps to buy the merchandise promised to the customers. But in the interim, Buffett uses this money not to buy low yield bonds but higher yielding businesses or company shares. This is something that the individual investor cannot do, The most we can do is to use a very limited amount of margin and that does not come cheap. I am convinced that Buffett's success from wise stock selection is augmented considerably by the leverage of the "float."

That brings us to Gilder. Gilder is best described as a "Futurologist." Based on some very simple but keen insights (defining abundance and defining scarcity), George manages to find the technologies that will be the winners in the market at some future date. These technologies can be in any of a great variety of states from PowerPoint presentations (EZ-Chip), to manual assembly (Avanex), to modern industrial mass production (Qualcomm and its value chain). A great many, if not most, of GG's companies cannot be evaluated with the standard tools of security analysis because they are too new.

A lot of the analyses people are asking GG to do on his paradigmatic companies simply cannot be done. There is not sufficient track record, several years of history of earnings and revenue growth. As I said before, GG is a futurologist and companies that don't really exist cannot be analyzed with the tools of security analysis.

If this analysis is not possible on most of GG's companies, how can you invest in them? The GTR readership can be classified by two criteria, technical and financial competence. That yields four groups of investors:

Readers		**Technically**	
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Group A. These investors are both technically and financially savvy and they are ideal candidates for The Gorilla Game investing strategy. I don't think I have much more to contribute for them.

Group D. For investor that are technically and financially naive, there is a simple but efficient strategy: take the same leap of faith that GG takes. Simply stated, buy all the companies on page eight in equal dollar amounts. The GTI calculated by Dick Sears is a fair indicator of the performance of this strategy. The GTI is more volatile than the NASDAQ and the S&P 500 which means that when the indices are positive, the GTI will do better than the indices and when they are negative, the GTI will do worse than the indices. To adopt this strategy you have to have faith in Gilder's ability to pick technologies and the companies that produce them. You might not know this, but Gilder is both an Angel and an Advisor at garage.com, a company that helps venture capitalists meets entrepreneurs. This gives Gilder considerable insight into the workings of companies at a very early stage of development.

The only real short term risk of this strategy is the possibility of jumping in all at once at the top of a bubble. The way to solve this problem is to buy the shares in stages. You could invest, say, a third of your investment money when you first subscribe and invest the other two thirds over a period of six months. Maybe you could buy one twelfth of page 8 every month for a year. Whichever way you decide to do it, the important thing to remember is that this is a Long Term Buy and Hold (LTBH) strategy and that you should not allow anyone to scare you into selling low just because the market is weak at some particular time.

Group B. The financially savvy but technically naive are not prepared to play The Gorilla Game. On the other hand, you might not want to buy all the companies on page 8. You might decide to screen out those that you consider are financially at great risk. For example, you might decide that you don't want to own foreign corporations because the SEC cannot enforce strict reporting standards and that would eliminate Terayon and Xcelera. Or you might decide that the impact of the bubbles on the bottom line of Agilent or the impact of Terabeam on the bottom line of Motorola don't justify purchasing these companies no matter how good the technology involved. You are looking for financial reasons that are strong enough to override GG's technical enthusiasm to weed out certain page 8 companies from your portfolio.

Group C. The technically savvy but financially naive also do not qualify as Gorilla Game players. They should buy page eight companies but they might weed out some of them based on technical expertise. For example, you might decide that the weight of legacy NetWare is so heavy on Novell that it is too risky to buy it based on the storage width concepts of directories being propounded by GG. You decide to wait until Novell spins off NetWare.

In each case, you are putting together the best of GG with the best of your own abilities. I don't think you can ask for more.

No matter which way you decide to invest, please remember that the one thing that does not work is to keep changing your mind, for example, to be a LTBHer in a bull market and a short in a bear market. I advise against trading but if you must trade, then you must first learn how speculators operate.

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