Posted to the Gilder forum - December 8, 1999

Thanks RJA!

---

posted: Wed Dec 8, 1999 4:41pm
author: RJA <b.auffenberg@att.net>
subject: Denny's Pearls II

As regular readers of the board are well aware Denny has been rather prolific recently other than an occasional hiatus. In order not to overwhelm the board with Denny's insights and investment philosophy I decided to post another collection of his "pearls" before they became too long. I hope you enjoy them as much as I have.

These "pearls" and the others I posted before seem to me to be a good "companion reader" to the GTR as they are filled with practical advice mixed with philosophical musings and humorous anecdotes.

Again, thanks to Denny for his invaluable contributions to the board.

rja (Bob)

1.- There are many investment styles: Value, growth, contrarian, gorilla, day trading, astrology (The Stock Split Report), small cap, large cap, micro cap, penny ante, Telecosm, Yardeni?, charting, just to name a few that come to mind.

You cannot mix and match all the techniques from all of these styles and use them all in a significant way. Let me list some of the techniques I don't use:

- Charting (except that I do look at price charts to see a general picture)
- Astrology or astronomy
- Yardeni?
- Price targets (good for cyclical and value plays)
- P/E ratios (not for gorillas anyway)

The most useful techniques for me are:

- What business are they in? Are they good at it — first or second in market share?
- Are revenues growing fast enough? Do they have earnings? Are the earnings growing fast enough?
- Do they have patents (good). What are the barriers to entry. Do they have law suits?

(for or against, both bad)
- Specially in non gorilla type companies, do they have good management, excellent execution?
- In gorilla type companies, how big and valuable is the value chain?

There are a few no-nos:

- Bulletin board
- Penny stocks (under about $10, the 12 1/2 was also in jest but serious jest)
- Law suits for or against
- Poison pills
- Most non US stocks

Most of the other facts and figures are useless noise for investors and useful fodder for writers.

A recent article about George Gilder describes how he investigates Telecosm companies. He does not talk to the CFO. He goes and talks to the engineers. He reluctantly talks to the CEO hoping that they (the CEOs) "get it!" For ten years I was a management consultant. One of the most difficult tasks with some of the clients was to try to explain to them that we wanted to talk to the troops and not just to the Board of Directors. We wanted to go out with the sales force on sales calls. We wanted to go out with the collections departments to collect. We wanted to walk around the plants and talk to the blue collar guys that make it happen. The only thing we wanted to ask the Board of Directors was: "Where do you want this company to go?" Peter Lynch invested in Hanes after his wife told him how convenient it was to buy pantyhose (L'Eggs?) in the supermarket. Lynch discovered the best retailers by going shopping with his daughters. He avoided the bad ones because his daughters would tell him: "But Dad, no one ever shops there anymore!"

Or as Yogi said: "The place is so crowded that no one goes there anymore!"

There are three essential ingredients to investing: decisions, decision and decisions. You have done the first one. Now do the next one when you think the time is right!.

There are three negatives to investing: greed, fear and hope, keep them at bay!

---

2. After reading the book [Gorilla Game] my question was: "How do I apply the technique described to the Telecosm?" Doing this made me realize that Qualcomm and Arm Holdings are up and coming gorillas and JDS Uniphase is a very powerful king. I am now searching the Telecosm for more of these beasts and royals.

---

3. http://garage.com/ GG is both an angel and an advisor there.

---

4. I'm just not interested in spending any time investigating it [A stock trading on the bulletin board at less than $4.]

---

5. Sorry, but that is a silly statement [The stock is one I could afford.]. If you have only $300 to invest, buy one share of JDSU. If you have $400, buy one share of QCOM.

---

6. There are no stupid questions, only stupid people who insist on staying stupid.

---

7. Thanksgiving is a truly American celebration, this holiday is not observed anywhere else in the American continent but maybe it should be. After all, the benefits and happiness that emigrants earn when they reach the USA, my family also received when we arrived in Venezuela. Hopefully Thanksgiving will become another American export to the world.

---

8. As GG has pointed out, one of the principal scarcities is life time. This should be reason enough for the average individual investor not to read the reports sent to the SEC. All you need are the vital statistics. Peter Lynch in "One Up on Wall Street" points out what these are: Revenues, earnings and quick ratio, and that, just about sum it all up. Once in the life of the investment, that is to say, before you invest, you do a more thorough investigation but the GTR and certain other publications often give a better insight than a report to the SEC which has many of the failings of PR pieces that you have often pointed out. Besides, who needs all those caveats that the lawyers force management to put in there?

---

9. I use mostly Yahoo. You can search the news for recent earnings reports both from the companies themselves and from news services.

---

10. The only way you can find out is by study. Study the back issues of the GTR. Read good investment books: "One Up on Wall Street" by Peter Lynch; "The Gorilla Game" by Geoffrey A. Moore, Paul Johnson and Tom Kippola; "Stocks for the Long Run" by Jeremy J. Siegel; "Money" by John Kenneth Galbraith; "Reminiscences of a Stock Operator" by Edwin Lefevre.

Learn technology, read "Microcosm" by George Gilder; Gene Prescott has a wonderful list of books to read that are technology oriented. I just ordered "Optical Networks" by Rajiv Ramaswami and Kumar N. Sivarajan [too technical, try "Understanding Fiber Optics" by Jeff Hecht instead - Denny]. GG has a great list of recommended books in the GTR site.

Build a short story for each stock and see if you like it: What business is it in? Competition? Patents? Revenue? Earnings? Management ability? Periodically you review the stories to see if it is a hold, a buy or a sell.

---

11. If you want a dip, go to a soda fountain. If you want JDSU, go to your broker. My choice between JDSU and GBLX favors the equipment maker over the service provider. I have 5 times as much JDSU as GBLX even though I paid 25% LESS for JDSU (a six bagger since January)

---

12. I'm not ready to invest in e-business, a field which, IMHO, will not support gorillas.

---

13. I have no idea if it will happen or when it will happen but it might happen, the bubble might burst. And my question is: "If and when it does, what are you going to do about it?" "How are you preparing yourself for this highly unlikely eventuality?" I'll tell you what I am doing about it. I want to continue to use a buy and hold strategy because it has proven itself to be superior to market timing. My fear is that I might be scared out of this conviction when the market or my portfolio starts to drop like a stone (at one time, I lost 25% in 3 or 4 months!). But if and when the dread event comes, I'll be able to face it in a cool, calm and collected way. I will have banished (I hope) fear! You might well say: "But you have not really done anything!" and you are, of course, right. But I will have prepared my mental attitude and I should be able to continue to use the buy and hold strategy.

---

14. The bible says that work is punishment imposed on man for his sins. That is the kind of work that I want to avoid. Rational acts are holding me in the market. The type of analysis that you do based on Gilder and The Gorilla Game are not an emotional exercise, they are an exercise of the use of reason. Let us remember that lower animals, non-rational beings, have only two ways of meeting danger: fight or flight. We humans have a third way, reason. And it has been reason that has built up the civilization that we live in and enjoy. Fight or flight produce wars and refugee camps. Reason produces a higher standard of living in a peaceful society.

---

15. Never bet against gorillas except when they are dead!

---

16. How trusted is this trusted friend [who recommended a particular stock]? Will this trusted friend give you back your money should this stock tank? My advice is that you should make up your own mind and then you can take the blame or the glory yourself.

---

17. Gorillas are not about size, elephants, whales and certain dinosaurs are a lot bigger. The first two were in danger of extinction and the latter are up in DinoHeaven.

---

18. GBLX is a sea calf and it will become a cash cow, so you see, it is still in its infancy!

---

19. ARMHY, ARMHY, ARMHY, ARMHY.

Why? Every person in the world will eventually have a mobile something and at least half of them will have "ARM" inside!

Being a fab-less chip maker, an IP (Intellectual Property) company, they have zero "bricks and mortar" costs just like the internet Godzillas but they don't have to give their product away for free and there are high barriers to entry in their business, money is not enough, you need the smarts.

ARMHY is a cross between a Gorilla and Godzilla (a Godrilla? a Gorzilla?).

Lots of room to grow. Compare market caps:

- ARMHY 10B
- GBLX 34B
- JDSU 40B
- QCOM 60B

ARMHY is the great undiscovered El Dorado, undiscovered by the US financial folks. Compare volume:

- ARMHY 76K ADRs
- GBLX 13.9M

- JDSU 2.6M
- QCOM 6.3M

Compare growth from Dec. 28, 1998 to Nov. 29, 1999:

- ARMHY 989% - 10 bagger
- GBLX 193% - 2 bagger
- JDSU 643% - 6 bagger
- QCOM 1399% - 14 bagger

ARMHY is growing 30% slower than QCOM, 1.6 times faster than JDSU and 5 times faster than GBLX. Disclosure: 3rd largest holding after JDSU and QCOM at 12% of portfolio.

---

20. I now look at the P/E ratio in a totally new (contrarian) light. If it is below 50 or so, the buying public is not enthused and, if there are no buyers, the price cannot go higher! If it is above 50, I just ignore it (the P/E, that is).

---

21. Can you find something that is growing faster now [ARMHY]? Do you see storm clouds on the horizon? I gave my opinion in the post above, why should I change it 24 hours later? But of course, I could be wrong and Telepathy could make a breakthrough within the next 18 months and the whole Telecosm spiel will go out the window and George Gilder will take up potato farming in Utah!

---

22. If management does not have the smarts, intellectual property quickly turns to garbage. Examples abound: Xerox missed the GUI game they invented at PARC. I firmly believe that Microsoft's success depends more on Bill's smarts than on anything else. Likewise for GE, it was Jack Welsh; for Dell, it was Michael Dell; for WalMart, it was Sam Walton; for the old IBM, it was both Tom Watsons.

That said and acknowledged and never forgotten (it led me to sell Terayon and Broadcom), the concept of the "value chain" is very powerful. While I was an IBM salesman it worked in my favor: "You cannot lose your job if you buy IBM." While I was an NCR salesman it worked against me: "You cannot lose your job if you buy IBM."

The third point to keep in mind is that you must not jump in too early. You have to give management time to prove itself, you have to give them time to build, or at least start, the "value chain."

If you keep these ideas in mind, the hunt for gorillas can be very profitable. If you don't play the game right, you'll be a loser like anybody who plays the right game with the wrong strategy and tactics.

Last but not least, I have stressed that The Gorilla Game is an excellent companion to the GTR. There are 8 or 10 thousand stocks out there and most of us, and I include myself, are not smart enough or have time enough, to sift through the noise to find the signal. The GTR does an absolutely superb job of getting rid of 99.7% of the noise. The Telecosm paradigm identifies, at this time, 28 potential Telecosm winners. By doing due diligence, the GTR readers can add a few more to the list and you [GG] have been kind enough to ratify some of our picks as worthy of inclusion in the list. This expanded list is where we should hunt for gorillas. You will have to admit that it is very difficult to make costly mistakes by following this rule. And it is highly likely that if we tilt our holding toward gorillas and away from technologically able chimps, monkeys, princes and serfs, the yield of the portfolio should be enhanced.

---

23. Price/Earnings. Price we know is right, it's what the last buyer gave the last seller.

Earnings? It's the output of a convoluted arithmetic system whose main purpose is to evade taxes and whose secondary purposes are to capture capital, to pay optionees lots of money and to beat analysts expectations by just a little bit (you can tell as many lies with accounting as you can with statistics).

A P/E ratio of 70 means that, if the company is not growing, it will take 70 years of similar earnings to earn the price of the share. Does not sound like a good deal. Value investors like P/E ratios of 5 to 10! But that is just not available in Telecosm. But if earnings are growing at 50% per year, then it will take just under 9 years to earn the price of the share. And if the P/E ratio is 200 then, at 50% earnings growth, it will take about 11.5 years to earn the price of the share. Still fairly close to what a value investor might find acceptable.

Let's take a company that is showing some totally unbelievable earnings growth. One of the GTR stocks' earnings grew 4 fold. This cannot be sustained so let's assume that in year 2 earnings grow 2 fold, in year 3 they double, in year 4 they grow 50% and from there on they grow at a 25% rate. Would this company justify a P/E ratio of 400? Well, it would earn the price of the share in just under NINE years! A value investor should be happy with that!

You don't believe me? Take out your spreadsheet and do the calculations. Compound interest does amazing things.

The arithmetic does not lie but we have to check to see if the growth rates are feasible or ridiculously high. Arithmetic will not figure it out for you. You have to understand the company and the industry. You have to understand the will of the people to communicate. You have to understand the huge amount of people on this earth. You have to understand price elasticity. You have to understand the S curve growth patterns.

If you believe that we are in the infancy of Telecosm. If you believe that without a cold war raging we have lots of capital to invest in the Telecosm infrastructure. If you believe that service providers are galloping at break neck speeds to try to achieve first comer advantage. Then you should believe that for a short few years, maybe 5 to 10 we will be able to sustain such incredibly high earning growth rates at least in some of the Telecosm industries.

My own take is that the service providers will wage enormous price wars and that very few of them will make any money at all. Only the ones with the best execution will make money. But the companies that will supply the equipment to the price warriors and the rest of the supply or value chain will earn heaps of money for several years. Long term buy and hold could be as short as three to five years in this crazy infrastructure build out. After that I think that things will tend to go back toward "normalcy," at least, somewhat.

Anyway, that is what I have to believe to stay in this market!

---

24. The object of the Investing Game is not to be right but to make money. If this technology proves to be a market success, you have plenty of time to get in when the risk level is much lower. After the first or second quarter with "real" earnings might be a good time and you should still get a five or ten year ride. In the mean time, put your money to work elsewhere with less risk (any one of the Gilder 9 will do).

---

25. One good way to make money is to be alone in your field of endeavor so that everybody has to buy from you.

Barriers to entry were high in the Mafia business because competitors were liquidated. If the wars got too hot, they divided the territory and signed a peace agreement.

In regular business barriers to entry might be patents (QCOM, Intel), need for very deep pockets (Globalstar), first entry advantage (no one ever lost his job buying IBM). I don't think this information is collected anywhere but as you get to know the companies, and even more important, the industries, these things will show up.

---

26. GG likes to use the comparison: "content vs. conduit." Conduit is the Telecosmic infrastructure. It's the collection of optic fiber, satellites, cell phone systems, radio systems and

the equipment and software that it is made up of. Practically all of the companies that make up the GTR paradigm list are Telecosmic infrastructure companies.

---

27. Ross Perot has a sign in his office: "Eagles don't flock. You have to catch them one by one." Same with investment picks (except for the Gilder flock of companies <VBG>). A hunter or fisherman knows what he is looking for and he knows the most likely place to find it. (As my ex partner used to say: "If you want to kiss, you have to look for a mouth!") RFMD and some other stocks I found through Navellier's MPT Review. MUSE I found by reading a McKinsey report. ARMHY I heard mentioned on this board and I remembered them from Apple Newton days. Once you find a likely candidate, you have to do your Due Diligence, analyze it according to sound investment criteria, revenues, earnings, competition and, very important, management. The Gorilla Game should give you some good pointers as what to look for.

---

28. Both MUSE and ARMHY happen to have a list of customers and partners that is a Who is Who of high tech. Some companies might give an arm and a leg to have such customers. The right questions in my mind are: "Can these companies grow into their outrageous valuations?" "What about competition?"

ARM Holdings shipped "only" 50 million processors in 1998. The forecast is for 100 million in the year 1999. I think the market may be several billion. It is highly likely that most intelligent portable gadgets will have "ARM Inside."

MUSE is becoming the leader in its field, monitoring and managing networks.

---

29. The only Telecosmic software that I really like so far is Micromuse (MUSE) and I keep searching.

---

30. You guys seem to forget that where people work is just as important as how smart they are. In a stifling atmosphere most people will wilt while in a go-go atmosphere they will reenergize each other. The same amount of smarts will do less for AT&T (unless they throw out the CEO with the bath water) than for GBLX.

---

31. Yes there are bubbles but generally the market knows what it is doing. You might want to

read about Competitive Advantage Period (CAP) which explains the current "ridiculously high" valuations. My opinion is that collective intelligence tends to out perform experts. That is why Democracy and Capitalism work while Socialism and Communism don't.