

Show Them The Time: The Super CIO and the Pumpkin Alert

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In our previous article we explored the pragmatic business of strategy creation and its implementation. In particular, we discussed the Holy Trinity - the three constituencies that must be satisfied with the strategic directions declared by the CEO: shareholders, customers and employees. In this article we specifically address the concerns of the shareholder, investor and/or investment analyst.

This article is written for investors and CEOs – for investors who must update their thinking, practices and skills, and for CEOs who must adapt to these changes and satisfy their constituent investors by shaping their companies and strategies to produce attractive investment opportunities.

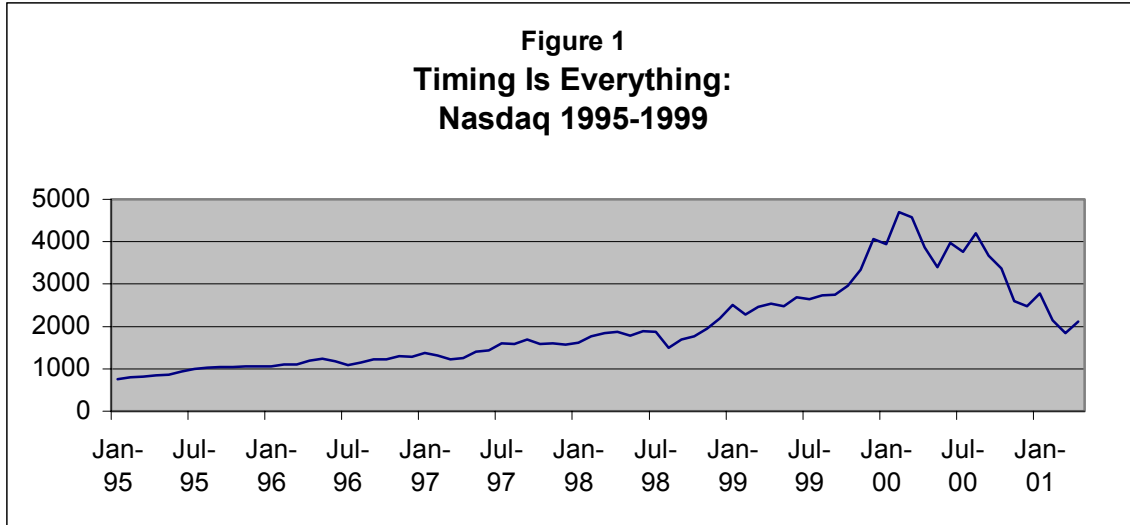
The “Pumpkin Alert”

The world of investing has changed a great deal. Many of the favored rules of thumb and principles for investing and company analysis are proving to be out of date at best and damaging at worst. Investors are beginning to see that they cannot expect past experience and common sense to lead them to the “prince charming” investments.

To navigate through today’s marketplace of investments a new guide is needed: the Super Chief Investment Officer (Super CIO). The new Super CIO must bring to analysis a new common sense, a new orientation to managing and making investment decisions. He must correctly identify when there has been a fundamental sea change that affects the value of all investments. Why can’t the average analyst do this? Here’s what we think.

As we’ve all noticed, the market has been unpredictable, made the mighty humble and enabled the meek to think they’ve inherited the earth. During the NASDAQ boom from 1995-99 we saw the “mighty”- Internet analysts like Henry Blodget who were able to navigate through the technological maze and lead investors through the bull market. (See Figure 1) Yet, when the market changed, these analysts were left behind, and so were their followers. Certain investors made a lot of money for their clients during the bull market but have now lost most of the gains made.

During this period we also saw the “meek” - the naysayers who didn’t profit from the NASDAQ climb, who didn’t benefit from the 400% tech boom, but who did get to be right, finally. As it turns out, more than a few stocks were overvalued. About these, the naysayer investors were right in the end, but their clients didn’t benefit financially. Many of these investors announced that stocks were overpriced as soon as the NASDAQ passed 1200 in 1996. What a missed opportunity!



So why did the naysayers miss the tech boom and why did Blodgett miss the tech decline? Perhaps it is because analysts and portfolio managers are true believers. They are romantic by nature and truly believe that their stocks are the scullery maids that have turned or will turn into princess Cinderella. They bond closely with the managements of the companies they analyze and come to love. This phenomenon, far more than the underwriting conflict of interest, explains why they can't sell when the market environment is no longer favorable to their stock selections.

But who can sound the “pumpkin alert” - a late-warning indicator that tells portfolio managers when the coach and four horses will turn back to a pumpkin and four mice? Who can tell investors to stop following Blodgett and listen now to the naysayers? In general, who can reveal the fad of the day as such and reorient colleagues and customers to stop following the herd? This is the job of the Super CIO. The new Super CIO must have the fundamental skills to maneuver through any market and be able to update beliefs when appropriate.

The Super Chief Investment Officer

When fiscal policies and economic environments are stable, rules of thumb and principles can be built and remain effective over time. However, since different stocks do well in different environments, when the world shifts, so must the thinking of the analyst. The Super CIO is a new role that is responsible for guiding through this change.

For success in today's changed and changing business environment there are three areas in which the Super CIO must excel to be successful. They are: 1) reading the forces that affect the economic environment and, thus, all investments, 2) managing the analysts' orientation, and 3) ensuring that analysts act consistently with the new orientation.

The Forces To Reckon With

There are two major forces, political and technological, to be reckoned with. The Super CIO must understand both when guiding analysts.

The first force is policy. Investors must **know the prevailing wind of policy and always work with the wind at their back**. The CIO must monitor the policies that affect all investments: monetary, tax and trade policies. Stocks are always at either the right price or the wrong price, but future price changes are much more likely to be caused by changes in the environment than by the market's recognition that they are mispriced. In other words, the notion of "fair value" is probably a dangerous illusion. Stocks do not know their own fair value.

We all know that the long term average stock market return is 11% per year. What is also true is that there are no average years or even average decades. Above average decades are always associated with cuts in marginal tax rates, capital gains tax rate cuts, and falling rates of interest and inflation. In fact, it's very hard to lose money in the market when the Fed is cutting interest rates.

If economic policy is poor, stocks will decline. They may appear to be "undervalued," but if policy stays bad or worsens, they will become even more "undervalued." There is no reversion to the mean. On the other hand, if policy is improving, stocks will probably be a great buy even though they may be up from their lows.

Of course, the effects of economic policy on asset returns vary by the nature of the policy in question. Falling interest rates favor certain industries over others; a weakening dollar favors exported-goods industries while a strengthening dollar favors non-traded industries; high-tax states, both U.S. states as well as foreign, depress competitiveness and corporate profits relative to businesses in low-tax states; an increase of business regulation imposes more costs on doing business and depresses the returns of those industries that do not adjust well to these new costs.

So, the Super CIO (and CEOs) must ask: are policies improving or getting worse? If they are getting worse, you can only play to lose less. If policies are generally improving, then play to win. The bottom line here: watch policy and ignore price.

The second force to consider is technology. Technology can fundamentally shift how we go about our work and life. Around new technology, radical and transformational changes can take place that produce hypergrowth markets and companies with superior products, revenues and valuations. If investors miss these markets they not only miss opportunities for investing in those companies, they may also be at risk for damage to the companies they already own.

So, successful investors must watch for and **identify hypergrowth markets by attending to transformational technological changes**. Hypergrowth markets occur around technological advances that have the consequence of collapsing costs. As George

Gilder has written so eloquently in *Telecosm*, the defining paradigm of our time is the collapse in the cost of processors and the collapse in the cost of bandwidth. These two steep declines have triggered hypergrowth in various markets because they produced an economic substitution affect. For example, in computing and telecommunications, silicon and glass fiber substitute for distance, space and time.

Hypergrowth markets are triggered when an abundant resource is substituted for a scarce one. Steam engine power displaced muscle power. Petroleum and the tractor replaced horses. The steam engine, the internal combustion engine and later the fraction horsepower electric motor allowed for the explosion of the industrial revolution. More recently, transistors substituted for vacuum tubes. Integrated circuits replaced discrete devices. Glass fiber is replacing copper. Each of these fundamental technologies displaced an older, slower and more costly technology and produced a hypergrowth market.

Chips and glass fiber are producing hypergrowth in communication, entertainment and in any other market where we can substitute the movement of bits for atoms. Graphics, color printing, digital photography, wireless phones, pagers and palm pilots are just a few of the hypergrowth examples made possible by the collapsing price of chips and fiber.

In sum, the Super CIO needs to be able to “read the forces” and to sound the pumpkin alert when policies turn hostile. He must be able to assess technology and the effectiveness of corporate strategy. He must remain unsentimental and allow his analysts and portfolio managers to be romantic and love their companies while policies are benign and managements are brilliant. He also needs to end the love affair when policies are adverse and managements are foolish.

Herding The Cats

From reading the forces we turn now to guiding the analysts, another necessary skill of the Super CIO. For our purposes here, this consists of orienting the analysts to adopt the following four principles.

1) Watch Power, Not Earnings

High margins and great returns on equity are the result of successfully implementing a good strategy in the past. Don't confuse them with the strategy for winning the game or gaining power now. Companies that acquire a dominant position in a growth market are likely to consume enormous quantities of capital and have low earnings. In fact, good earnings growth might coincide with a loss of dominance, as with IBM in the 1980s. The business game is won and rewards are reaped by playing the power game well.

To be a better observer of power than your competitors is not as hard as it seems. The business schools teach everybody to watch the wrong thing: earnings. The hardest part about learning to observe power is letting go of that notion.

What should we watch to assess a company's current or growing power? First, assess whether they are positioned to achieve hypergrowth. Companies that rapidly convert non-customers into customers will gain power and achieve hypergrowth. Hypergrowth probably never occurs by taking market share. Market share is always well defended. Hypergrowth occurs by converting non-users to users. It occurs by competing with the old ways of doing things.

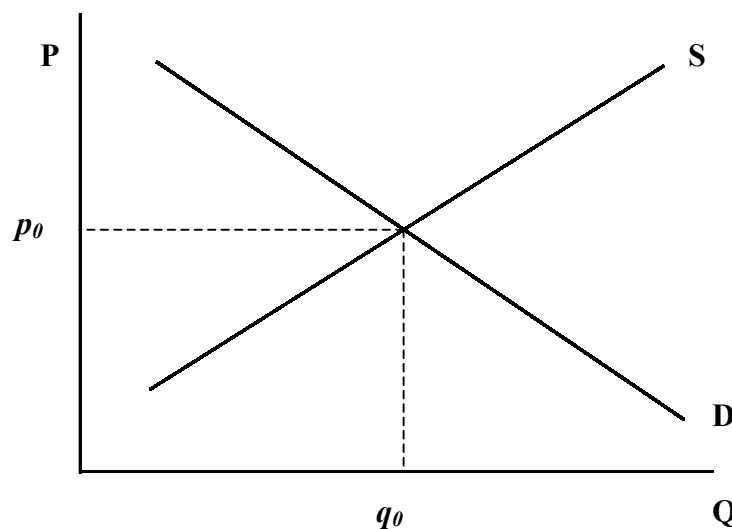
For additional criteria for watching power, we refer to Geoffrey Moore, particularly his latest book *Living On The Faultline: Managing for Shareholder Value in the Age of the Internet*. He includes: technological advances (particularly those that include patents, increasing barriers to entry for competitors and barriers to exit for customers), market segment leadership, execution focus and differentiated offerings. All are more crucial to observing power than current earnings.

2) Watch The Supply Curve

The notions of supply and demand are critical for CEOs and investors to remember when assessing strategy and future returns. Here's a bit of a primer.

Demand curves are downward sloping; supply curves are (hopefully) upward sloping (Figure 2). The elasticity of supply is measured by the slope of the curve. A vertical curve is supply inelastic. This means that **any increase in demand will be accommodated by an increase in price**, not an increase in the quantity supplied. In this case, rising demand equals rising profitability. A flat or horizontal curve is supply elastic. Any change in demand will be accommodated by a change in quantity, not a change in price.

Figure 2
Supply and Demand Curves



Investors hate flat supply curves. Somebody else supplies all the increase in demand and profitability remains marginal. The world hates a vertical supply curve and will do everything to kill it because a vertical curve indicates a firm that is gaining power and is a monopolist.

So, CEOs and investors must avoid businesses whose supply curves are flattening. Don't stand underneath a flattening supply curve.

3) Don't Sell Your Winners

Stocks don't fall because they are overpriced. Don't make your sell decisions based on price. Stocks don't rise because they are under priced. Don't make your buy decisions based on price. It is up to the Super CIO to remember this.

If you have the enormous good fortune to buy a company before it comes to dominate its market, don't sell! Stocks don't know they are overpriced. If a company has operating problems, don't sell the stock. In fact, buy more.

The problems facing any company can be divided into two categories: strategic and operational. Strategic problems - like a bet on the wrong technology, a misinterpretation about what customers want or the wrong alliances - are very difficult to fix. Operational problems - like a new plant that doesn't start on time, a slippage in a product release date or missing the quarter due to parts shortages - are incredibly common and they can be fixed. Hypergrowth companies usually have operating problems. Pray for them! They give you the opportunity to buy more

However, if the company begins to lose power - if its market is maturing, if competitors are disrupting either its technology or its business model, if executives are "buying market share," or any of other indicators of a loss of power or a poor strategy - sell, sell, sell! Of course, the stock will already be down significantly, you can't be the only one to have noticed the loss of power, but don't let the price decline trap you in a company that is losing its power.

It is the job of the Super CIO to make sure the judgment is made as to the source of the problems and steer investment decisions accordingly.

4) Don't keep your losers

We believe the investment business is organized ineffectively. It is dominated by bright people who can't stand to be wrong. We lesser mortals don't like to be wrong either; we just get more practice at it.

Investment departments strive to avoid mistakes. This is not the way to build wealth, although it may be the way to build egos. To build wealth, investors must make mistakes and correct them early. The Super CIO must be ever vigilant to the "looking good" syndrome and adjust portfolio holdings when necessary.

If a company is behind the power curve, its stock can never be cheap enough. Companies that are behind the power curve are losing margin, losing customers, losing value chain members, losing talent and losing shareholders. Stocks that are down are not necessarily cheap; they are just lower in price. Your clients will forgive you for catching a mistake; they won't forgive you for continuing to hold the stock of a company that is obviously losing power.

The rules of thumb presented here are by no means complete, but they are fundamental principles to consider when investing in today's marketplace.

Insure Consistency

Analysts and portfolio managers are humans. As humans, it is difficult for us to change direction. When policies change and the star analyst is no longer picking the star companies, the Super CIO needs to sound the pumpkin alert. The alert must be sounded not because the analyst suddenly got dumb and dumber; but because he is blind and blinder to the effects of the change in policy on his choices. The Super CIO needs to insure that the analyst will take the actions inconsistent with the former point of view. It will be unfamiliar but rewarding.

Based on our personal experience, it is very difficult to see and sound the pumpkin alert. We have made many mistakes as well. All of us love Cinderella and the beauty of the ball. But alas, that story has had a costly ending for investors.