COBURN VENTURES

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The Encyclopedia of Growth, Value and Pillars of Jell-O

Four Heretical Essays

Coburn Ventures

Growth and Value

CIO DIARY: *Growth and Value*

November 2020

"Change and investing are synonymous..."
- Eldon Mayer

GETTING INTO THE BOX

When folks start talking about "Growth versus Value," I hear two areas of questioning:

#1 INVESTMENT DECISIONS:
Growth and Value as it relates to the underpinnings of the roles of growth rates and value metrics in investing at either a stock or portfolio level.

#2 MARKETING/CONSULTANT INTERACTIONS:
The conversations "growth" investors have with clients, prospects, and consultants.

I am going to separate them out from one another for today.

Perhaps it is part of the critical path to meaningfully advance the ball on #1 (investing) so that we can be grounded in our communication challenge on #2 (marketing).

It is important to meet the clients/consultants where they are. They insist we designate ourselves as box #1 Value or box #2 Growth. It is a very convenient way to reduce and organize decision-making. Long, long, long ago, I had the opportunity to interview an extremely well-known successful investor who I admired from afar. He seemed incredibly annoyed by spending this time with me. By most standards, he might have been considered flat-out rude. When I asked the Growth or Value question, his annoyance jumped to another level. He railed against consultants. He said, "I can't be classified."

None of us can be classified.

Because we are amenable to being designated for business purposes in no way means these designations define our work.

Our orientation is that it is good to get in a designated box – unless I am OK having a small business or wish to shrink my current business. Growth and Value are the relevant boxes our industry has used to organize and grow TAM.

What perhaps we can do is help those implementing the boxes to get smarter while feeling zero resistance from us on this vital organizational "growth/value" tool they will be using perhaps forever.

More on marketing in a following piece.

For today, maybe I can offer a few additional, relevant angles to help reshape this question.

STARTER QUESTIONS

#1 WHY HAS GROWTH BEEN TROUNCING VALUE?

My shortest answer: The incredible disequilibrium set in motion with the mainstreaming of the Internet – a "Meteor Strikes Earth" development.

#2 WHEN WILL WE HAVE A MEAN REVERSION TOWARD "VALUE"?

My shortest answer: Mean reversion is an entirely inappropriate orientation between these two "camps."

#3 #2 RE-STATED. WHEN WILL "VALUE" DO BETTER THAN GROWTH FOR AN EXTENDED PERIOD?

When disequilibrium drastically moderates toward something more "stable."

#4 IS GROWTH INVESTING SOMEWHAT RECKLESS?

My shortest answer: Any activities done mindlessly without process and discipline can be reckless, but the unstated recklessness implicit in the market psychology toward "growth" is misorienting and damaging.

#5 PART #2 – IS GROWTH INVESTING SOMEWHAT RECKLESS?

My shortest answer: The discipline assumed in "value" investing (as compared to "growth") is completely inappropriate as a starting point, as value investing sits on a critical foundation I term "Pillars of Jell-O."

#6 WHAT ARE THE PILLARS OF JELL-O?

My shortest answer: 90% of valuation approaches are mathematically tied to DCF. DCF rests on pillar #1 of BETA with ludicrously low explanatory power. Beta feeds to WACC which generates ridiculous sensitivity: pillar #2. We could further destroy the DCF model easily. "Discipline" can't comfortably rest on Pillars of Jell-O.

#7 THE CORE STUDY IN THIS PROCESS IS CHANGE.

ELDON MAYER'S AFTERNOON WITH BENJAMIN GRAHAM TALKING "CHANGE"

I come at this two-decade faux controversy of Growth versus Value from a somewhat unusual background/ perspective I suppose.

"WAIT!"

Geesh…I am barely out of the gates and I go and say, "faux controversy!" Can't even get going without getting side-tracked!?! I can't just move forward now that I have

dropped that faux controversy idea into the bucket!

OK...here is my thought on why this is a faux controversy.

There is an embedded assumption that these are two "camps" and there will either be (1) some form of natural mean-reversion between the two and/or (2) philosophies that support "growth" or support "value" are TRULY the RIGHT ones and this is a debate about which one will "naturally" be right 80% of the time by default.

I don't think either of these two framings has merit.

#1 NOT A MEAN REVERTING RELATIONSHIP

There isn't a mean reversion natural phenomenon between these two camps if I am even forced to acknowledge them as distinctive "camps." These aren't "camps" but, rather, organizing mechanisms that helped clients (investors) get their minds around who to hire. Those in the profession of managing other people's money might be incredibly grateful that this ridiculous organization mechanism of "growth" and "value" have been tools for marketers to expand the TAM of our industry by simplifying decision-making for people with money who find it all so, so confusing! An additional tool has been the mix of stocks and bonds relative to age. It reduces complexity but with a degradation of signal that comes with it.

This growth and value framing HAS helped expand our industry, but shouldn't be taken too seriously!

But "growth" and "value" don't have a mean-reversion relationship.

We will come back to the "Pillars of Jell-O" framing that points to the idea that even separating out the starting point of value and growth with lines of demarcation based on perhaps 2021 PE's is ludicrous.

#2 NEITHER PHILOSOPHY IS RIGHT: CHANGE/DISEQUILIBRIUM IS THE THREAD FOR FOCUS

Similarly, neither "growth" nor "value" philosophies are THE right ones.

The underpinning element of this study is change.

I was once told that change and investing were synonymous. It took me many many years of active resistance before I actually came to fully embrace this idea.

In periods of massive disequilibrium, our supposed valuation "tools" will be outrageously ineffective.

In periods of RELATIVE stability, those supposed valuation tools will be less ineffective.

"Disequilibrium" stretches the potential future range of outcomes.

CRITICAL POINT:
A greater degree of disequilibrium is not inherently good or bad.

Disequilibrium allows for a far wider set of outcomes...

Including #1 from the pie that is GROWING a LOT to SHRINKING a LOT....

...and #2 from major MARKET SHARE STEALING

...and #3 MASSIVE NEW WINNERS

...as well as #4 CURRENT INCUMBENTS LOSING massively

...and #5 many many many start-ups that are activated some of which we will never remember and FAILING TREMENDOUSLY...

When disequilibrium is substantive, major moves occur almost routinely...

There is more chance for both #1 PROGRESS and...

there is also a greater chance of COLLAPSE...

Wide wide wide wide outcomes

Some people find jumping into this mess of change incredibly enlivening! I know I do. It's a personality fit. I think of "offense" and what can we create and, wow, THIS is the time to be alive to help advance things. The risk of horrible outcomes is worth it.

Others might reasonably prefer less downside risk that all this disequilibrium could lead to horrible outcomes and we ought to hang on to the current way of life even if it isn't ideal. Others may go so far as to romanticize about nostalgically going back to a prior period we recall too fondly without seeing the major warts of that time.

#3 VALUE DOESN'T HAVE AN EDGE OVERGROWTH IN DISCIPLINE VS. RECKLESSNESS

Finally, "value" has been viewed as "disciplined" and thoughtful, and "growth" as ultimately always reckless.

This is so, so unfortunate. I have seen both highly reckless value and growth investors, and also value and growth "traders" masquerading as "investors." Neither group has a monopoly on recklessness. What's unfortunate is that "growth" folks can feel a tad defensive when the world presses them to the wall and can feel inadequate in handling these attacks of presumed recklessness! This is unfortunate because it can lead to bad decisions among growth investors. After all, they have grown at the margin to wonder if they ARE being reckless.

I think it is good to look at the CHANGE first.

Similarly, many value investors have gotten their heads handed to them by and large for 25 years and often continue their same method which seems "disciplined" and (uggghhh) "rational" without truly looking at the basic inputs of their method and challenging them aggressively.

OK…back to the start….

Eldon Mayer's Afternoon with Benjamin Graham

I am weird.

I thank my mentors for it.

I get to study change every single day of my life.

I started investing at a wonderful mid-sized firm, Lynch and Mayer. This is where I was brainwashed about "change." It took me about 36 hours to become infatuated with change and I have been so, so excited nearly every day since thinking about change. I think across the past 25 years, I have been in the top percentile of loving what I get to do and having immense enthusiasm. Hopefully, that has fueled my learning and that my accompanying delusions all along the way have been not too damning.

Back at that time, consultants were starting to grow more and more relevant and with that came… boxes. You know, which box do you want to be in, "growth" or "value"?

Well, what we did was sort of 75% "growth" and 25% "value."

We were focused on the change.

Our marketing group organized our "change" into four patterns and two of those were (1) restructurings and (2) turnarounds. We were all over the place thru the lens of "growth" versus "value."

We just did what we did and then the marketing group labored to force our work into the "boxes" that were becoming more important in the industry. The industry of money management was still becoming more "professional" in some ways. Massive fragmentation. Massive. Serious consolidation had barely begun. Consultants were still growing in number but had yet to become the force of today. What we did in "change" in 1994 – that resulted in 25% value and 75% growth – would likely today only have been tolerable to a small part of a similar client base.

Somewhere in perhaps 1997, we had a neutral assessor look through our work in our largest product. They said we had significantly shifted our style from 5 to 7 years earlier. I think what had happened is we were subconsciously getting more and more into a box of "growth" and forsaking our truer North Star of "change." We had been brow-beaten every day to get in a BOX! And even though we were led by investment, not marketing, we were not impervious to invisibly forsaking our heart and soul. In the process, we likely also collectively lost some of our change acumen!

In my first two years with Lynch and Mayer, I worked on Tech and Casinos which were growthy, but also Oil Field Services which most certainly was not growth but was certainly going through "change." And I worked on all sorts of odd situations such as a turnaround at Westinghouse. I loved working on turnarounds. I analyzed a large number of them because it was "change" in potential disequilibrium with non-linear outcomes! I learned to LOVE situations that had a wide range of potential 2- to 3-year outcomes! It meant I better grow my ability to understand change so that the wide, future range of outcomes was NOT a random walk but rather might be stacked in my favor!

Then the cell phone, local area networking, and the

Internet happened and "tech," which was only 6% of the S&P heading into the 4th quarter of 1994, started its outrageous rise to supremacy over everything!

I mention this because I wasn't raised on "growth." I was raised on "change."

The creator of our philosophy was Eldon Mayer.

Eldon was well-placed in the community (and super smart) and as such, in the late 1960s, he had access to spend an afternoon with Benjamin Graham, so the story goes, and an opportunity perhaps to secure the foundational blessing from the legend himself. At the end of that afternoon, he blessed Eldon's approach. Essentially, Benjamin Graham understood that he had always used his cherished book value as a key heuristic for comprehending the range of true values for a company. But Benjamin Graham understood it was a heuristic, not a precise inherent answer! An underlying assumption was that the specific utility of the assets wouldn't actually change too quickly. Whether you had a building or a pitchfork or an 18-wheeler on the books, that specific asset's utility wasn't apt to change too much inherently. It was a key assumption. CHANGE was assumed as modest.

With that in mind, what Eldon suggested was that if someone understood the patterns of CHANGE well enough, they might understand the change of the value of the assets and the company in total as it separated far away from the proxy of book value.

This afternoon session was well before the phrase "knowledge economy" became popular. This was only 2 to 3 years after IBM released the Series 360 computer to the business world, which is perhaps today the most underappreciated change of the last century when considering how it trip wired the next 55 years of change after change after change…and still more to come…all of which has undermined the solidness of book value of assets. We likely haven't even begun, frankly. It is only NOW that we starting to think that office building value is incredibly nebulous as we are suddenly in an omni-channel work world.

Eldon's CHANGE orientation made sense to Benjamin Graham.

Of course, this CHANGE philosophy demanded that Eldon grow his ability to see the change patterns and be somewhat early so he could benefit as more of the market might come to understand this separation between book value and "real" value. Fortunately, Eldon was exceptional at confidently making decisions and not being deterred by possibly being wrong, which is the nature of our craft. Eldon exuded "Offense." He despised "defense" couched as "thoroughness." He knew great ideas would be gutted of their magic quickly by so-called "common wisdom."

Eldon did not suffer fools gladly.

Eldon did not like marketing meetings. He hated the boxes. He despised "stupid" questions from consultants.

Marketing was always nervous at the potential intersection of Eldon-meets-Clients.

RECKLESSNESS

I think it would be easily understandable if so-called "Growth investors" developed systematic inferiority complexes…

…even in the presence of having won so much during the past 25 years.

Maybe instead of "inferiority" complex, I more so

mean "recklessness complex."

Everyday growth investors are asked to DEFEND their supposed recklessness.

Implicit: "Isn't your recklessness THE reason for every crash from Tulip Mania to The Dot-Com Bust??"

I recall time and time again at UBS – where I started as Global Technology Strategist in 1999 – being accused of not caring at all about valuation by someone. **ACCUSED is smack on the right word.**

In 2001, I wrote a 150-page document on VALUATION, in part I suspect (sub-consciously) to provide an accessible but deeply grounded orientation to valuation that might dismiss the idea that I was one of those reckless types. I had fortunately studied valuation deeply. There are – as you all know – so so many things I don't know about and things I am naïve about and things that have never hit my radar screen. But valuation is not one of those.

So, yes, it would long ago gnaw at me when someone might casually, lightly accuse, "So, you don't really care about valuation?"

"Valuation" is a process, and I LOVE processes perhaps almost as much as I love change. Processes ABOUT change are almost too exciting to me, as many of you know!!! I promise to not rewrite 150 pages here today!

I think perhaps subconsciously it all starts there...

...this growth versus value comparison.

Value is positioned as DISCIPLINED.

Growth is positioned as RECKLESS.

False camps to begin with, BUT with loads of framing nonetheless!

We are all signaled indirectly or directly that "value" investing has discipline associated with it. We are also told that "growth" investing is often a code for recklessness... sloppiness...manias. We are to believe that it is always that sloppy, undisciplined recklessness that led to Tulip Mania as well as the Dot-Com Bust. "Growth investing" is sometimes painted as a neighbor to speculation and naivety. There is no true comparison to the framing of "recklessness" on the "value investing" side of things. There is for sure "missing upside" because of discipline and there are "value traps," but those rarely make headlines.

Value investing is even associated with contrarianism and bravery. Growth is associated with the "herd."

Value investing need not answer critics questioning thoroughness. Growth is always on the defense.

Imagine a job interview. What is your greatest weakness? Answer A: "Sometimes I am reckless." Answer B: "Sometimes I am too disciplined."

Answer A might cost you the job.

Answer B might win you the job.

I think these biases are ridiculous.

#1 GROWTH BLINDSPOT:
These "hidden in plain sight" pressures on "growth investors" may systematically constrain success and alter otherwise sensational decisions.

#2 VALUE BLINDSPOT:
If "value investors" don't question the foundational assumptions, they may only one day long, long from now think that the "discipline" sat on top of what I refer to as Pillars of Jell-O.

Both results above would be unfortunate.

I am going to dig in.

PILLARS OF JELL-O: DCF

When I joined UBS in the spring of 1999, I was immediately asked to join the stock recommendation committee in the US. What this means is that across my six years at UBS, I was involved in every rating change across all industries. I think they wanted someone with a buy-side analyst + PM background to chime in. Something happened about three years in. Thanks to a deep investigation of our industry, suddenly analysts had FAR tighter requirements of (1) being required to have loosely the same number of buys-holds-sells and (2) perhaps more important for this note, they had to have explicit target prices that justified the mathematical upside of a "BUY," for instance. And every major firm had to be in compliance which meant that on any given day, some analyst was making a mad dash into the committee to alter their price target! WHAT THEN HAPPENED would have been funny if it wasn't so sad. The analyst had to DOCTOR their price target to, for instance, maintain a "BUY" and then had to justify to the committee the WHY. WHAT was it they had so recently discovered about this company that merited the increase in the intrinsic value of the stock?

This all assumed "intrinsic value."

Intrinsic value is 90% a useless concept.

And as the market went up, justifications grew more and more pathetic.
The math behind DOCTORING DCF models became so much more delusional.

But the growingly popular academic CFA program fully embraced this delusion as a discipline! Aye ye ye!

The greatest degree of delusion of this DCF valuation likely occurred in Tech... which is the "beauty" of the methodology. By "beauty," I mean it was investment bankers' dream come true! A fully-endorsed (even by academics) set of tools that legitimized and unleashed them being snake oil salesmen. Some may remember Jack Grubman or Henry Blodgett or Walt Piecyk. They dialed up a crazy array of valuations to justify "BUY" ratings. Instead of the chicanery, they might have just said "I have a BUY rating 'cuz I want to and I will get paid more...". But Tech was a ripple. Closer to the start was all the leveraged buyouts of the 1980s. RJR Nabisco. Barbarians at the Gate. KKR. Michael Milken. The movie Wall Street.

DCF was the legitimizing tool. Add in some MBAs and well-pressed expensive suits and who is to argue??

90% of valuation approaches are mathematically tied to DCF. The others are typically even worse.

PILLAR OF JELL-O #1: **If you are disciplined in "valuation," you necessarily LOVE Beta. This Pillar of Jell-O #1 of BETA has ludicrously low explanatory power.** Actual scientists like our friends Maria Souza and Steve Crandall would, I strongly suspect, be appalled if they looked at what we are doing in finance.

PILLAR OF JELL-O #2: **Beta feeds to WACC which generates ridiculous sensitivity – Pillar of Jell-O #2.**

We could further destroy the DCF model easily.

"Discipline" can't comfortably rest on Pillars of Jell-O.

The underpinnings of "valuation" itself ARE what is indeed absolutely RECKLESS.

William Sharpe won the Nobel Prize in Economics.

It was a serious mathematical concept. It had massive problems in the real world. We might be better off if his work wasn't absconded.

A decade later, Dan Kahneman won the Nobel Prize in economics. He was a behavioral psychologist. The economists of the world were told they required a psychologist. Imagine how many Economists were livid when they heard that the Nobel committee had given "their" prize to a psychologist. The failure of "efficient markets" leads to a search for better, more human answers.

Dan Kahneman had been building those answers for 30 years.

William Sharpe HAD TO win his Nobel Prize first.

His model HAD TO fail first so that humans would search for a real-world model that had real-life wisdom.

1994: DISEQUILIBRIUM

Eldon Mayer once told me that change and investing were synonymous.

As much as I loved change, I didn't actually believe that change and investing were truly synonymous.

I would tell people of Eldon's wisdom and quickly follow it with, "I don't actually believe what Eldon said. I think there are many investment philosophies that work as long as I don't try to do them all and wind up like a bag of melted caramels... but I do deeply believe in Eldon's change philosophy and so I just focus on it..."

More and more, I think I more clearly understand his wisdom.

I have been thinking that the successful use of the mediocre absolute valuation DCF tools at our disposal is linked to the level of disequilibrium in a situation. When

all is somewhat stable, the common valuation tools work somewhat better. When disequilibrium is significant and seemingly ongoing, what we really want to deeply understand is the change. Sometimes we call change: "growth." Sometimes we call change: "implosion." The way I studied change wasn't with a leaning toward up or down or good or bad or growth or implosion. It was just change. And the change may be everything. In high change, we get so-called "other room" ridiculous valuations as well as "value traps" that soon fade from existence.

When the range of expected outcomes becomes extreme, the idea of a known inherent value becomes ludicrous.

We can't overlay ANY of these valuation tools without a view of the situational context for change/ disequilibrium.

If change is immense, the tools become worthless because, again, the valuation frameworks engendered by William Sharpe sit on top of Pillars of Jell-O.

If change is extremely modest, the tools become somewhat more valuable. We can, for instance, use discounted cash flows to price US government bonds in the moment.

So, in periods of relative equilibrium, we might intelligently inject a smidge more "valuation" into the process.

Since 1994, the world of business has had immense disequilibrium. Maybe I could count further backward to 1989 with the fall of the Berlin Wall which upended the "stability" of the Cold War. Maybe I could point to globalization and the rise of China as a superpower as well. It is hard to remember, but the Beijing Olympics of 2008 had been in some ways touted as China's coming-out party. China 1994 didn't have anywhere nearly the global weight as China 2020! Maybe I could site the growing understanding of global warming and climate change and a massive question mark for how the business world might even function twenty years from now.

But I pick 1994.

The year the Internet quickly started its meteoric push to the mainstream.

It was a major fundamental change to human life and business to consider that some legitimate attempt to provide access to "all" of the world's information was beginning... today, this change is underappreciated for the magnitude of ripples that were created...

I imagine tsunami after tsunami after tsunami being unleashed for twenty-five years...

Our observation was that, fundamentally in 1994, we changed the human relationship toward asking questions. We had unleashed data and knowledge in all sorts of previously unimaginable forms and forums from Wikipedia to AOL groups to millions of accessible databases. We unleashed our latent questions. We were getting answers! I use "unleashed" quite often.

There is a fundamental change to the human experience and (not surprisingly) from a change perspective, the ripples would be massive and ongoing. When you significantly monkey around with critical variables/ assumptions in a complex system, the results are typically significant, widespread, and ripple for a long time.

And the basic modes of conducting business would experience alteration after alteration and lead to an extremely wide (unimaginable) range of expected outcomes. Tsunami after tsunami after tsunami.

We had no idea about iPods or Smart Phones.

We WERE starting to accept that the pace of change was accelerating. WHAT an understatement!

The investment world, which likes to consider that big change conveniently fits its disruption into a fresh steady equilibrium inside 12-month time frames so everything can get "priced in," is STILL adjusting to a reality of ongoing dynamic ripples.

Hah!

GROWTH CRUSHES VALUE

When I hear the "growth or value" question, I often think, "Are we still talking about this?"

Maybe we have the wrong question.

Growth has been crushing value since 1994 with some key lapses. But mainly it has been lopsided.

It reminds me of the past 20 years of the Ohio State versus Michigan "rivalry"… ("Oh, gosh, Pip…I thought we might get through this piece without bringing Ohio State into the discussion…")

Ohio State has won something like 18 of the last 20 years!

There was a fundamental nonlinear change 20 years ago around head coaching that has rippled forward into nearly every aspect of the football program and built advantage upon advantage that is hard to suddenly repeal.

And the Internet has been a nonlinear change agent.

The Internet was a slower motion "Meteor Strikes Earth"… and still is. I will use metaphor after metaphor after metaphor if it helps me appreciate the disequilibrium.

I consider this specific disequilibrium is WHY "growth" has been largely "crushing" value ever since.

The discounting model of the world suggested that the

full effects of the Internet – as – Meteor Strikes Earth change would happen quickly, and a new equilibrium would be established.

People and businesses would quickly adjust. Quaint.

An efficient markets theory for real-world living.

Not at all.

"Maybe in five years it will have 'played out.'" The investment world tortures itself with phrases like "played out" or "it's already in the stock" even when it can't see the IT.

In 1999, the iPod wasn't yet popular. Google was getting going. Facebook didn't exist at all. Mark Zuckerberg was only 15. No iPhone. People weren't talking AI or even "data science" beyond small little bastions. The dot-com bust hadn't yet happened.

There wasn't even... Peloton.

Seriously. It's true.

No Uber.

No Flash Mobs.

No Arab Spring.

No Saleforce.com.

No Space X.

No Alibaba. Not even Ant Financial.

There was absolutely no 5G.

Serious.

There wasn't any fake news! Well...

The change isn't slowing.

Investors – and most all humans – are in 2020 asking about "how will we work" in what we term an omni-channel world.

To slow down on this again...we aren't merely asking about what we might create to sell. But at a far deeper level, we are asking about how – where – when – what will be our work. And our friend, Elliot Noss, offers that there will be infinite mutations. Change? Game on. Game just starting. Disequilibrium accelerating. This next single change that TRULY lacks any single "correct" answer is going to drive managements and employees bonkers!

We are now 26 years into the disequilibrium, and it isn't slowing.

If we want to insist on thinking about such a competition, in greater disequilibrium, "growth" (which in business terms means "good change") will crush "value." The value tools become all the more feeble and non-believable.

And investor generation after investor generation grows into their careers not really caring about book value or being limited by "rational" DCF-based valuation methodologies sitting on Pillars of Jell-O.

Along the way, we "enjoyed" a Dot-Com Bust and Global Financial Crisis that served to cleanse the publicly traded markets of a lot of the rubbish which had been flowing unfiltered into our world. If anything, public markets were quickly overly protected as the most interesting emergent companies would have 2-3 public/private financing rounds before finally arriving into our world.

This filtering process for public markets means that today here in 2020 the massive amount of rubbish that one contended within the dot-com era 20 years ago is kept out of our sights!

I DO think "Growth" versus "Value" has been the wrong question.

VALUE TRAPS AND ZEITGEIST OF ORGANIZATIONAL STRUCTURE

There is only cold comfort in PEs of say 8x.

When Warren Buffett suggested he wants a "margin for error" in valuation he meant perhaps a discount to book value or a discount to a peer group average PE.

A friend recently offered that the better margin error indicator is the degree of conviction in 2- or 3-year cash flows NOT some somewhat arbitrary "valuation" calculation.

Warren Buffett used to say he liked to invest in gatekeeper businesses that could be managed by a monkey because one day they would be (his disbelief in the likelihood of multiple generations of good management). The internet has resulted in fewer gatekeeper businesses than we

would have ever imagined. Our 2006 phrase "Routing Around Institutions" has been far more powerful ad infinitum than we could have expected.

I plummeted into my first value trap in 1995.

Digital Equipment Corp…known as DEC.

I thought they might be able to freshen up this old product line of computers and put some lipstick on that old product line and find users of some of their semiconductor fabs and…I missed EVERYTHING! Including – and I hope you caught it yourself perhaps – that a computer company used to own its own semi fabs! Good gosh! I visited them once and at the end of the day they showed me some new stuff they were working on including a "search engine." DEC had a technology called ALPHA. Alpha was likely the first significant search engine. It was mind-blowing as they walked me through it.

OMG!!

"Do you have thoughts about how to make money on this??"

They shrugged their shoulders. No idea.

DEC never became…Google.

One day they embarrassingly sold ALPHA to Intel for trinkets.

The key point: when disequilibrium expands the former leaders can QUICKLY become value traps. It is amazing. The speed.

ORGANIZATIONAL STRUCTURE AS NEXT DISEQUILIBRIUM

A final note.

In the past two decades, the zeitgeist of organizational structure has dramatically shifted. It is far further than merely the "Omni Channel Work" we have been citing.

Organizational structure used to be VERY VERY hierarchical. If you asked someone to draw an org chart, it always looked pretty much the same: a few people on top and a gazillion people reporting "up" at the bottom. I even took a class at Brown called "Organizational Structure" and it boiled down to a series of math problems, ALL of which assumed hierarchical reporting lines and zero touchy-feely thinking.

There wasn't much talk back then about "flat organizational structures." Much of the "flat" has been an ineffective rebellious worker revolution against "hierarchy," but it

started a far more nuanced examination of multi-faceted efficacy. There was no "company without borders." The phrase "outsourcing" wasn't so common when I was at Brown. Michael Porter's Five Forces was the name of the game, and all about using and abusing leverage OVER the others in the food chain including customers! The idea of "partnership" among organizations was naïve.

"Not everything that counts can be counted, and not everything that can be counted counts..." - Albert Einstein

Times change.

The dehumanizing and often massive ineffectiveness of hierarchy tendencies is more widely understood.

Those old business org charts in my college class ALWAYS had two blocks above "CEO." Just above CEO was the BOARD OF DIRECTORS. Just above the Board of Directors was "INVESTORS."

Today, even the laggard public market is comprehending multi-stakeholder orientation which means there is no single topline group and structure.

So much disequilibrium ahead.

Pip

COMMUNITY FOR CHANGE

Essay 2:

Growth and Value: Two Pillars of Jell-o

CIO DIARY: Growth and Value: Pillars of Jell-o

October 2020

"Sometimes [Mr. Market's] idea of value appears plausible and justified by business developments and prospects as you know them. Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly."

- BENJAMIN GRAHAM

PIP'S LEAD IN:

When I joined UBS in the spring of 1999, I was immediately asked to join the stock recommendation committee in the US. What this means is that across my six years there I was involved in every rating change across all industries. I think they wanted someone with a buy-side analyst + PM background to chime in. Something happened about three years in. Thanks to a deep investigation of our industry – if anyone recalls trigger people like Jack Grubman – suddenly analysts had FAR tighter requirements of (1) having loosely the same number of buys-holds-sells and (2) perhaps more important for the moment, they had to have explicit target prices that justified the mathematical upside of a "BUY," for instance. And every major firm had to be in compliance which meant that on any given day some analyst was making a mad dash into the committee to alter their price target! WHAT THEN HAPPENED would have been funny if it wasn't so sad. The analyst had to DOCTOR their price target so as to, for instance, maintain a "BUY" and then had to justify to the committee the WHY about an increase in intrinsic value.

The justifications grew more and more pathetic.

The math behind DOCTORING DCF models became so much more delusional.

I was doing tech-internet-media-telecom where some of the greatest delusion in method occurred perhaps…really stretching…THAT, of course, is THE "beauty" of the DCF model from the standpoint of investment bankers.
How so?…they can stretch this model to argue for far greater upside in a deal price to almost anything… we saw this in the 1980s and 1990s with so many leveraged buyouts that indirectly led to hospitals being built and then named after famous…private equity "leaders" ??? Yep. The DCF-model and new hospital wings being built are directly related.

We have more to say about growth versus value coming just ahead. (And to be clear, Dan's main point below features a slightly different topic than my next statement coming in about 3 seconds… here we go…)

When I hear the debate of value versus growth, it is often positioned as "disciplined"(value) versus "reckless"(growth).

This is UTTER NONSENSE!!!!

The underpinnings of "valuation" itself are absolutely RECKLESS.

I think of three of the main avenues of "valuation": (1) book value – even Benjamin Graham would today suggest this is useless 95% of the time; (2) PEG – which has zero mathematical grounding; and... tah-dah DCF...

So many of the major valuation methods are either DCF or a mathematically-linked heuristic.

So...if I am a so-called "disciplined" value investor, I am going to lead with valuation, which means I am BY DEFINITION attaching myself tightly to the "discipline" of DCF.

Discipline?

If I am religious about valuation and DCF, then I am actively subscribing to the discipline of TWO of the worst foundationally "non-grounding" elements I can recall in ANY model I have ever used that aimed to pass itself off, again, as "disciplined":

#1 WACC...which means I LOVE beta; beta is a tool with such low explanatory power that this entire model ought to be laughed out of the park for practical real-world usage.

#2 DCF... degree of crazy sensitivity from alterations in the WACC... the width of answers is insane. That is all fine as long as I don't portray myself as "disciplined."

Non-sense.

The underlying pillars are made of Jell-O. (the state food of one of my many adopted homes: Utah)

And if I ever think price/sales or anything else has any distance from DCF, that is just flat out mathematically off. I can do book value; I can do PEG (almost makes logical mockery of our profession) or DCF...DCF is the mathematical connective tissue.

So, if I am doing "growth" and paying "crazy multiples recklessly," it may be a decent thing to consider that we can create a means to orient and distinguish between high growth that can make sense, and that which cannot. But if I am doing "value" investing and I don't recognize the "pillars of Jell-O" upon which my method stands, I am truly reckless.

More on growth versus value soon.

Back now to Dan and a price target that jumped 10x in one day!!!

-Pip

FROM DAN

As we brought up in last week's *Rancid Coconut Water*, the overlap between "ridiculously" overvalued companies and monumental change businesses is often...unsurprisingly, high.

It's actually likely that, over the last 10 years at any given time, perhaps 30% of the monumental change universe was what some would term as unjustifiably, ridiculously valued.

Trafficking in monumental change, to some extent, necessitates participating in a number of these companies. But, to some extent, it's a pick your poison situation:

Participate in insane valuations today

OR

Participate in the insanely sensitive, dubiously accurate tool that is a DCF. (See Pip's framing/rant above.)

Regardless, out of necessity, we've attempted to refine an early-warning detection system of sorts, looking for signals that might puncture a story, so that we might be systematically long gone before bad share price moves occur...

One head-scratching situation that we came across recently, an example perhaps of a research system that is messed up more so than a specific stock/company issue (although on that front we aren't positive) is with Carvana (online car sales).

(PIP ADD: Well, it would be "head-scratching," but we have been around the block several times and are not surprised by what the system can kick out. In this case, the DEGREE OF CHANGE Dan cites below is staggering! You might decide to tell friends.)

Specifically...

Two weeks ago, Morgan Stanley raised their price target for Carvana from $23 to $215.

Yes, a nearly 10x increase in their target price.

What mental math gymnastics did the trapeze artists at Morgan Stanley undertake to make such a leap?

They lengthened their timeframe to give more "optionality" to their framework.

Their previous price of $23 was based on a multiple of 2023 EBITDA.

How do they arrive at the new one? Using a **10-year DCF!**

- **Revenue growing at ~30% CAGR for 10 years. (30% for 10 years! OMG!)**
- Carvana's market share in U.S. used cars reaching 5% by 2030, versus the largest used car retailer today (CarMax) which has 2%.

So what?

1. It's hard to say this is about anything other than somehow back peddling away from having a sell rating FORCED on a stock that has moved from $100 at the start of the year, bottoming at $30 in March, to $215 today.

2. When one valuation metric doesn't work just change it or strettttccccchhhhh it....

The previous price target imagined 12x a 2023 EBITDA of $475m.

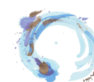
The new model still only has 2023 EBITDA at $645m...it's tough to get to the necessary valuation by raising EBITDA 35%, but the multiple paid from 12x to 75x.

So...let's just go to the old reliable DCF but push the numbers wayyyyy out.

(PIP ADD: The approaches are connected by DCF anyway as the common valuation connective tissue of most all...)

3. By moving the focus out 10 years, far, far away from anything in the near term – the analyst has removed the burden of proof from the company.

Said another way – in this new framework, Carvana is already successful at reaching the 2030 goal, unless proven otherwise. This fits right into our Other Room Framework, where a company is successful unless there are real punctures to the tires, not just bb's bouncing off the hubcaps.



Essay 3:

Growth, Value and The Fallacy of Terminal Growth Rates
"The Third Pillar of Jell-o"
The Real Math Behind "Compounders" Valuations

MINI -CIO DIARY: Growth, Value and The Fallacy of Terminal Growth Rates

"The Third Pillar of Jell-O"

The Real Math Behind "Compounders" Valuations

November 2020

Heuristic Overdose: Working Definition

"An unconscious cultural allure and cultural norm of going fast and in the process forsaking valuable information as well as faultily applying mediocre common methodologies and in the process significantly undermining efficacy…"

A few weeks ago, we suggested that value investing is perceived as disciplined and growth investing at "extremes" perceived as on the edge of recklessness.

We offered that the disciplines of valuation were built on Pillars of Jello. Most common valuation work is mathematically tied back to DCF. DCF is built on beta and WACC. It is hard to imagine anyone truly LOVING beta -- one of the VITAL Pillars of Jello. It is hard to imagine those desiring discipline LOVING the sensitivity generated by WACC and extreme sensitivity as a CRITICAL characteristic of WACC.

I make a point to not mis-use words like **VITAL or CRITICAL.** These two words have a very very specific role in our language.

So when I say **VITAL and CRITICAL** with regards to beta's very low explanatory power (and other massive shortcomings) and WACC's sensitivity as its inherent critical nature, what I mean, said another way, is that those elements are UNAVOIDABLE.

If you are a super disciplined value investor, it is very very hard to not implicitly embrace these massive factors. Virtually unavoidable.

Yet, they are Pillars of Jello.

Are there other ways to bring valuation in to investing in an enhancing/complementary way? Absolutely. It takes some significant thought, but, absolutely.

In a period – such as 1994 to the present – is the

exaggerated instability affecting the business world the cause of greater heartache where disciplined "valuation" (based on implicitly embracing the Pillars of Jello) meets investment? Yes.

FOR TODAY:

"Growth" can, no question, also be amazingly delusional!!!

If growth is conditioned on instability, it is typically helpful to bring in methods of understanding and application of instability meeting a business and market place. Often instead – and with the understandable pressure of looking at a gazillion situations and keeping up with the fire hose of data – folks default to an **unconscious cultural allure** of what maybe I might term: "heuristic overdose".

Heuristic Overdose

"An unconscious cultural allure and cultural norm of going fast and in the process forsaking valuable information as well as faultily applying mediocre common methodologies and in the process significantly undermining efficacy…"

We might rush through the Four Stages of Data Development offered by J.P. Rangaswami: Observation, Diagnosis, Prediction, Prescription.

It is tempting to condense the four stages down into one, single, real-time step that parrots common thinking. We can all hear this activity in a separate setting. At coffee shops worldwide, friends advise friends on what they "should" do playing the role of family or personal therapist/counselor even though there is an entire profession that has developed actual skills. We have collectively perhaps watched too much Dr. Phil and are sloppily making stuff up… that sounds good… while a profession really exists with differentiating skill!

There is a difference between "sounds good" common "wisdom" and really knowing what we are talking about!

Same thing happens with the study of instability, change, growth.

Sometimes going fast is amazing! We gain time dividends with zero loss of fidelity. (e.g. listening to a podcast at 1.2x speed).

And in other instances we offer that…

"Sometimes it pays to go slow, so later we can go fast…"

Going below the surface becomes perhaps a critical path toward conviction. Garden variety thematic investing probably won't get us there.

I love a quote from Roger MacNamee: ***"Life happens to the left of the decimal point."***

I hear this quote in a couple ways.

#1: ANTI-PRECISION

Maybe Roger is warning against my ludicrous attraction toward considering that maybe maybe I could have precision to the right of the decimal point automated by my excel sheet. A mentor, Eldon Mayer, once called me out at an offsite for an investment case I generated where he worried that I ***actually*** thought I was smart enough to "know" that General Instruments would earn $1.68 in two years. He said us humans weren't smart enough to know such a thing with such precision…. but he offered that we were smart enough to learn patterns of change and degrees. I did neither in that case. If I recall General Instruments instead did maybe $1.25 instead of my $1.68 estimate!

#1A: ANTI-PRECISION PART #2

Perhaps the greater toxicity than merely being less attached to the precision is that I might be deluded that I could be ”certain” about the first number to the left of the decimal point… or the second number to the left of the decimal point… or the third…

“It ain’t what you don’t know that gets you into trouble. It’s what you know for sure that just ain’t so…” -MARK TWAIN

#2: REAL-LIFE

Maybe he is warning that I ought to make sure I don’t become a spreadsheet monkey merely assembling a bunch of numbers and tweaking growth rates (and tilting up margins year by year by year). Maybe I first ought to understand more about what will be happening in the real world (life). That real-world perspective will generate more relevant figures. If I can gain an understanding about society, systems, organizations, people and the resultant markets, I might then have a useful perspective to begin the discussion of what growth rate actually might make sense. Otherwise, I may become the sloppy coffee shop adviser – meets – business analysis. It will be easy to sound reasonable with common thinking, but, we are all paid for systematically generating “insight” which we consider being an uncommon understanding.

We want to have uncommon understanding (insight) systematically sitting underneath all of the business analysis that leads to the investment decisions we make.

COMPOUNDERS

We can play with growth rates on a spreadsheet.

We can talk about valuations.

But if we can understand change/instability richly, the growth and the value will sit on a much much stronger foundation.

“Investors are quite tempted to work backward from valuation as opposed to forward from change…”

A THIRD PILLAR OF JELLO: THE FALLACY OF TERMINAL GROWTH RATES

Most of the prominent valuation methodologies today are mathematical short cuts for DCF. A group of PEs in a table all are reflections of and linked to DCF. Every DCF hinges enormously on a ridiculous assumption that after X number of years our DCF itself might afford a big big big assumption that a terminal growth rate might be standardized.

This is one heckuva ridiculous assumption. Almost as ridiculous as the word “heckuva” for starters.

Voice-Over from Investment Banking VP:

“What ought we implicitly standardize for terminal growth for ALL companies in this PE spreadsheet ? 4% ? 5% ?”

Choosing between 4% or 5% in itself is a big deal to so-called **“inherent”** value calculations. This terminal growth rate short cut is used so that I don’t have to calculate the next thousand years of discounted cash flow year by year which would be time consuming and ridiculous. This

heuristic is reasonable perhaps given the immense time savings so long as we don't get ourselves "locked in" and understand when this short cut might backfire. When does it dive into Heuristic Overdose?

One answer: when we miss the magic of compounders.

This "Fallacy of the Terminal Growth Rate" is the SINGLE MAGIC MATHEMATICAL ASSUMPTION upon which investing in "compounders" rests. Rather, investing in "compounders" takes advantage that comparing PEs rests in this assumption of identical terminal growth rates for all companies after 8 to 10 years. In other words, IF we think that company X is truly going to be a compounder versus the industry, it is not reflected AT ALL in comparing PEs. PEs default to typical terminal growth rates but they really really don't apply for high quality compounders.

That is the opportunity mathematically.

If we generate conviction in our prediction of future instability (growth/change) that a certain "compounder" can outgrow the assumed terminal values for an extended period, then we will know that the table of PE calculations is incredibly wrong. We can then take advantage of the lack of comprehension in the investment world that most major valuation methods are mathematically linked to DCF (including PEs). Said another way, P/E and P/S are shortcuts for DCF… and DCF has a huge short cut in standardizing terminal growth rates.

Compounders are specifically, definitionally, those businesses that outgrow those implicit standard boiler plate terminal growth assumptions.

To play with some numbers just a bit, Dan ran a couple scenarios:

CASE #1:

With EBIT margins (20%), tax rate (21%), Capex/D&A/WC, WACC (10%), all held constant he fiddled in a model between two growth situations. In Case #1, growth was 20% for 8 years and then dropped to 5% terminal

Scenario 1: 20% growth for first 8 years (forward year 1-8), 5% terminal growth after.

Scenario 2: 20% growth for first 8 years (forward year 1-8), 10% growth next 10 years (forward year 9-18), 5% terminal growth after.

The current DCF calculation of scenario 2 is 37% higher than scenario 1.

In other words, an additional 10 years of 10% growth as opposed to 5% leads to a 37% higher DCF calculation. The 2021 PEs are ridiculously understated for a compounder and, as such, if we can generate uncommon understanding (insight) leading to higher conviction in a compounder, we can instantly translate the degree to which the stated PEs are substantively faulty.

(Note: This is not, here, even mentioning that a "high quality compounder" is more apt, definitionally, to have far less disappointment against a set of multi-year expectations! Here, we are assuming--I realize ridiculously--that all companies hit the base numbers in the first 5-10 years or so! Hah!)

CASE #2:

Moving on to the more extreme case with higher initial growth.

A company grows 40% for 5 years then downshifts to 20% and then 5% after year 10 in the first model. In the second, the growth is still 40% for 5 years, followed by 20% for 5 years just as in the first instance. But then growth drops

to 15% for 10 years before hitting the 5% terminal growth rate.

SCENARIO 1: 40% growth for 5 years (forward year 1-5), 20% growth for next 5 years (forward year 6-10), 5% terminal growth after.

SCENARIO 2: 40% growth for 5 years (forward year 1-5), 20% growth for next 5 years (forward year 6-10), 15% growth for growth for next 5 years (forward year 6-10), 15% growth for next 10 years (forward year 11-20), 5% terminal growth after.

In this situation, the DCF calculation of scenario 2 is 90% higher than scenario 1. If I only recall this sensitivity on terminal growth rates when contemplating compounders (or high growth stocks), I can remember that the out year PEs REQUIRE significant adjustment. The DCFs are still undermined logically either way. But we can quickly increase the value of the "valuation" work.

In all of this, our intention in aiming to better and better understand change and instability is such that there might be a strong foundation under everything. The upside of generating higher conviction, specifically, in what a "high quality compounder" truly is seems enormous.

QUOTE COLLECTION

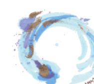
"Sometimes it pays to go slow, so later we can go fast..."

"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so..."-MARK TWAIN

"Life happens to the left of the decimal point..."-ROGER MACNAMEE

"Investors are quite tempted to work backward from valuation as opposed to forward from change..."

"The power of compounding is the greatest force in the universe..." -ALBERT EINSTEIN



COMMUNITY FOR CHANGE

What is Change?
An 11 Step Chain-Link Study of Instability

CIO Diary: What is Change?
An 11 Step Chain-Link Study of Instability

November 2020

"Change and Investing are synonymous."
- Eldon Mayer

Last week, one of our clients asked:

"Pip, I read the Growth and Value piece you recently wrote... but I need help... you have studied 'change' for a long time but I don't truly know what 'change' is...and I want to in order to understand the Growth and Value note....What is 'change'? And what are you really studying when you speak of studying change?"

This is perhaps one of the 10 best questions I think I have ever been asked!

And I thought, "*Wow! Where do I start?*"

So, for today, I am going to dig into my answer.

EVERYTHING in our universe is continually changing. This isn't meant to be a cliché. And I mean "continually," not "constantly" changing. "Continually" means at every single milli-nano-second or even shorter. "Constantly" means very often but, in this case of thinking of "change," "constantly" would imply some periodic stops for, let's say equilibrium or stability.

I am alluding to **continually** as a starting point.

"Everything in our universe is continually changing" is meant as an observation and our human understanding of everything from quantum physics to emotions. So, while it looks like this computer and my lap desk I am working on are "solid," they aren't. It is ALL continually changing in each milli-nano-second.

Fortunately, certain combinations seem to work where there are objects that can appear somewhat stable for our human purposes. This is really good news, I think! It reduces the potential for far greater chaos. For instance, whatever it is we call a "table" might still look like a "table" if we came back in 5 years or a hundred years. The composite through our senses is pretty "stable." Imagine if we humans could see at a quantum level? Good goodness that would be horrible. It is extremely helpful for us humans that certain composites seem stable through our senses. And, some of the human time scales involved in instability are far, far longer than our extremely short life spans as either individuals (80 years?) or as a civilization (6k years) or as a species (100k years).

It is very hard for us to see the water and wind erosion

that formed the Grand Canyon.

I am seriously NOT aiming to go existential on y'all, but without reminders of continual change as a base starting point, I might get sucked into seeing stability – against my training since 1993.

"This too shall pass."

Instead of orienting to "continual" instability, us humans have been somewhat tricked into considering that EVERYTHING is fixed. Understandable. We see things at a composite level (e.g. table) and in short time frames where it doesn't appear much is actually changing.

It is understandable in an additional manner: perhaps we so, so want certainty in such an uncertain endeavor of being a human on some planet somewhere in a solar system somewhere in a galaxy somewhere in a universe that we tend to want to move strongly toward "stable" answers. We know better than to truly latch onto "stable" to an extent...but we behave as if we have forgotten this. For instance, many of us with children, know that they will grow and disperse and we ourselves will get older, but much of the time we might act as if these things weren't so.

"This too shall pass."

So, in studying change, we are studying instability.

A couple of weeks ago, we discussed that we study disequilibrium. That is another way of saying it.

One trainer in Saratoga has me use a "stability" ball.

I keep reminding her that it is really an instability ball. While most balls are not stable to a certain extent, the instability ball is especially and magnificently designed to induce instability.

AN 11 STEP CHAIN-LINK

Below, we will aim to connect "change" to our method and intention through chain-linking 11 ideas about our study of instability. The 11 points are meant to operate as something of a logical build to attend to the question about "What is Change?" and "What are you studying and why?"

So...

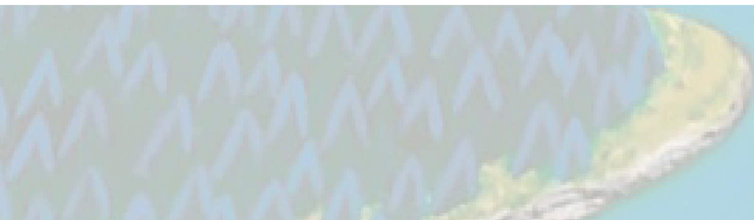
#1 We are studying instability.

We are studying patterns of instability. There are so many patterns that repeat when we get closer. We study instability to understand it a bit better day by day by day.

#2 We study the pace of instability.

We want to know the pace at which instability will reveal itself in our human experience. If I can count on the visible composite of a table to remain a table five years from now that is important information. Can it still be a 'table" in a hundred years? That is important information. What about that thing we call a "building"? Can it still be a building in 20 years? 100 years? How about that fence? A bridge? Are they good for 5-8 years or 20 years or 200? How about the paint job?

Is a car considered "instability" such that it is replaced every 7 years or every 13 years or...?



That BIC pen plastic shell has a very long time to instability. A BIC disposable razor blade, on the other hand, has a far shorter time to instability.

How about our ways of doing things? How about how we work and move? Travel by train or car or airplane or subway or rocket are fairly recent developments that seem "stable," but each has changed dramatically as we look past the labels.

What about our human attitudes? What is the pace of instability in how we think about tobacco or sugar or bowling or "organic food" or college education or Facebook or therapy?

The list is infinite.

What is the pace of instability?

#3 We study the degree of transformation in instability.

What if the table turned into a pillow in five years?

That would be a super important distinction.

If something changes as dramatically as a table becoming a soft pillow, we might even term that "metamorphosis" because we consider the change so, so large. The physical appearance of a table is much different than a pillow much like a caterpillar and a moth appear so, so different.

And as we study instability for the purposes of conducting business analysis, we are also studying the change of function as opposed to merely the degree of change of form.

It is one thing to say that a table becomes a pillow physically, but from a business analysis point of view...

"SO WHAT?"

The "what" in "so what?" is shorthand here for...

"What can humans now do differently with the new form (pillow) as opposed to the prior form (table)?"

So, we are studying the function of the forms as one micro-second of instability moves to the very next micro-second to understand utility in the human-geared world.

#4 We study the instability in function.

Often the instability has nothing to do with the physical reshaping of a form, but rather the change in function. So, we study instability in function.

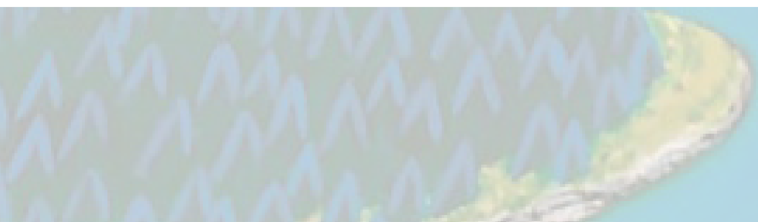
#5 We study instability in the context of business analysis.

This means that we are interested in studying instability in the context of humans and the many market places of exchange we create.

#6 We study instability's intersection with humans.

Therefore...

#7 We study societies', systems', organizations', and individuals' intersection with instability.



We study to be able to observe, diagnose, and predict this instability.

Ok....

In thinking about the ways how marketplaces might change, we want to study and understand as richly as we can the nature of certain instability, and what causes acceleration or deceleration. For instance, if we considered that there might be a shift in the market for sugar, we may want to go well past the perception of benefit (taste) and cost (diabetes) at a societal level and understand addiction to sugar, the effect of marketing on the mind, and lobbying efforts that affect regulation in our governing systems. It is notably odd to us how little the investment world understands, for instance, how lobbying in Washington D.C. works from a perspective of studying instability.

Sometimes the systems dramatically affect the nature of the instability.

We also do want to understand the nature of societies. For instance, why does a society start to connect sugar and diabetes when 20 years earlier it was largely ignored? How do these altered perceptions ripple through marketplaces?

We also study organizations and their ability to generate instability in marketplaces, or even in themselves. The word "resilient" has recently been lauded as incredibly positive...but "resilient" regards the ability to resist deep and prolonged disruption before returning to its norm. It is neither absolutely good nor bad. Sometimes we don't want organizations to be resilient! We want organizations to change drastically. So, we study internal feedback loops, which our dear friend Maria Souza understands very richly through her passion for biology.

By "organizations," we don't just mean what we all call formal organizations. "Organizations," in this instance, the way we are using it, might include a wide array of groups of individuals from a concert crowd to a family to a chat group to a legally formed corporation.

And, finally for today, we study individuals.

#8 We study what humans want.

In a sense, we also study what societies and systems and organizations want as well.

For today, we will start at individuals.

In this regard, we might merely start at the product level and notice "change" and do a slipshod attempt to diagnose and predict the next quarter or year, even two years. J.P. Rangaswami offered us a model entitled *"The Four Stages of Data Development": (1) observation; (2) diagnosis; (3) prediction; (4) prescription.* Most humans (and especially organizations of humans) want to merge all of these stages into ten seconds...or faster! You can overhear this in coffee shops. Person A reveals a personal drama and, within seconds, Person B faux-diagnoses the situation and then faux-prescribes ("advises")": "Here is what you got to do...". We often seem to measure ourselves in our speed to prescription ("real-time is preferred, thank you" more so than efficacy). Usually, the real-time coffee shop friendly faux-advisor is nowhere to be found when the game plan is put into effect with all sorts of fall out.

With this in mind in studying instability, we aim to build tools constantly to study a layer below the surface.

#9 We study and create tools for examining instability in humans.

We don't want to "just" develop a surface-level assessment of a product or service.

We study as richly as we can the nature of human nature and the human condition to deeply understand what humans really want, no matter what the standard industry code (SIC) or the specific marketplace might be. I think it was Peter Drucker who once said that God didn't invent SIC codes, humans did. Exactly! We want to understand humans and organizations and systems and societies at a richer level so that we can generate a more powerful "diagnosis" which might be turned into "prediction" and "prescription" and lead to business analysis and projection of future cash flow.

About 14 months ago, we shared "10 Unavoidable Ideas."

These are observations of human and organizational conditions. Each of the 10 ideas is a tool we study to help us diagnose and predict. We have been digging into such tools for 20 years.

I am going to offer an example of a tool: the study of "mobility."

So, when we think, for example, of "mobility" (as one of the 10 Unavoidable Ideas) we don't just immediately think about products such as smartphones. We will first think of mobility as a proxy for freedom and humans' longstanding desire for various forms of freedom. Physical mobility is one form of freedom for humans. So, designers/companies that skillfully and artfully build mobility into their products and services, all else equal, will have an advantage. So, if we study mobility deeply enough, this becomes an internalized tool we can use to diagnose and predict instability. Our second nature might develop to see mobility in smartphones to luggage to refrigeration to the improvements in lid covers for coffee at Starbucks and cup holders in cars.

We also might see "Inverse Mobility," in which businesses reduce the NEED/BURDEN of mobility placed on its customers.

"Minute clinics" that are just around the corner providing access and shrinking the drive time (and waiting time perhaps) to a doctor. In fact, the registered nurse and telemedicine become "Inverse Mobility" factors from which you might receive the benefits you wanted without "having" to endure the tax of the supplier demanding your mobility (and time). Distance learning. Remote work. "Mobility" is such a powerful force that often we quickly give up other benefits almost instantly. We choose mobile phones and dropped calls over a landline's quality. We choose digitized Spotify on our phones over analog stereo systems.

#10. We are studying instability below the surface of products and services.

We are studying below the surface of products and services so we can understand patterns that then become tools to more successfully assess/diagnose most any product and service.

Without these tools to understand instability more richly, our "diagnosis" and "prediction" are left at truly surface level. We will merely start to parrot what others are saying or thinking because we overheard it on the news or read it in a weekend spotlight in the Sunday paper as if those creators of media content have the real answers. If our thinking is too imbued by common inputs that are purposed to seek attention ("'Media' is the business of attracting attention." – Om Malik), we will only be saying common things.

We just become part of the circle of noise. We are often too guided and influenced by sources that are operating at a surface level and quite often in a very, very biased fashion. As in they have an economic or emotional stake in what they are saying. But even below that, we are all invisibly impacted by our worldviews and daily inputs and "common wisdoms" which, left unchecked, can drastically slant our observation, diagnosis, prediction, and prescription unwittingly.

Our working definition of insight is:

"a deeper, uncommon understanding of a particular matter that allows us to more effectively predict the future."

The most critical word is uncommon.

If we only see and generate "common" understanding, it will be hard to make money as an investor above and beyond a randomly generated capacity.

If we are utilizing common inputs and using common means of processing, we will likely end up with common understanding as opposed to uncommon understanding. So, our intention to study below the surface is to generate an uncommon understanding of instability that leads to predictive efficacy and "alpha."

#11. We are studying instability to generate uncommon understanding – to systematically generate insight.

That's the link.

I hope for that one client, this 11-step chain-link about change and why we study it through instability might help further your own pursuit of systematic insight.

More to come...

PIP

"Anything that is in the world when you are born is normal and ordinary and is just a part of a natural part of the way the world works. Anything that's invented between when you're 15 and 35 is new and exciting and revolutionary. Anything invented after you're 35 is against the natural order of things."

—DOUGLAS ADAMS

"The significant problems we face cannot be solved at the same level of thinking we were at when we created them."

- ALBERT EINSTEIN

COMMUNITY FOR CHANGE