Are You the Fool at The Table? Steve Blank

My friend Ben Horowitz and I debate the tech bubble in The Economist . This post is the 8220rebuttal8221 statement to Ben8217s opening comments. An edited version of this post originally appeared as part 2 of 3. Part 1 is here .

You8217ve got to know when to hold 8216em
Know when to fold them
Know when to walk away
Know when to runKenny Rogers The Gambler

My esteemed colleague Ben Horowitz essentially makes four arguments : 1) look at how relatively cheap Apple, Google and Amazon stock is compared to their growth; 2) Major technology cycles tend to be around 25 years long with the bulk of the purchases occurring in the last five-to-ten years. The major adoption wave for the Internet technology platform will hit in the next 8 years; 3) the economics of building Internet businesses has changed; 4) the markets are much bigger.

Therefore Ben concludes that boom is coming...and do you want to miss it because it has the possibility of becoming a bubble?

If this were a magic act, wed suggest that Bens arguments are misdirection. To answer the question before the house, Are we in a tech bubble? Ben offers that as Apple, Google and Amazon survived the dot.com crash, we can ignore the fate of the thousands of failed public and private dot.com companies when the bubble burst in March of 2000. I believe the issue isnt whether were on a 25-year tech cycle or that the next 8 years are really going to be great. The issue is \textit{whether the next 100+ tech IPOs carried by this bubble will be worth their offering price in 8 years}.

One of the least understood parts of a bubble is that there are five types of participants: \textit{Smart Money, }the \textit{Shills}, the \textit{Marks}, the \textit{True Believers} and the \textit{Promoters. }Understanding the motivations of these different groups help make sense out of the bubble chart below.

\textit{Smart Money} are prescient angel investors and Venture Capitalists who started investing in social networks, consumer and mobile applications and the cloud 3, 4 or 5 years ago. They helped build these struggling ventures into the Facebooks, Twitters, and Zyngas before anyone else appreciated these companies could have hundreds of millions of users with off-the-chart revenue and profits.

In a bubble the smart money doubles down on their investment in the awareness phase, but when it starts becoming a mania \textit{the smart money cashes out}. (Really smart money recognizes its a bubble and bets against it.) They manage this all with knowledge of the game theyre playing, but \textit{they dont hype it, talk about it or fan the flames}. They know others will.

The \textit{Shills} are the middlemen in a bubble. They profit from the boom times. Theyre the mortgage brokers and real estate agents in the housing bubble, the investment bankers and technology press in the dot.com bubble. Since its in their interest to keep the bubble going, theyll tell you that housing always goes up, that these bonds are guaranteed by a big bank, and that this tech stock is worth its opening price. All the stories peddled by Shills have at their heart why its a new age and why all the old ways of measuring value are obsolete. And why youll be an idiot if you dont jump in and reap the rewards and cash out.

The \textit{Marks} are your neighbors or parents or grandparents. Theyre not domain experts. They know nothing about real estate, financial markets or tech stocks, but they dont want to miss the 8221investment opportunity of a lifetime8221. They hear reassurance from the \textit{Shills }and take their advice at face value, never asking or questioning the Shills financial incentives to sell you this house/mortgage/tech stock. They see others making extraordinary amounts of money at the start of the mania (just buy a condo or two and you can sell them in six months.) What no one tells the Marks is that as theyre buying, the smart money and institutional investors are quietly pulling out and selling their assets.

The \textit{True Believers} dont financially participate in the bubble like the Marks (lack of assets, timidity, or time) but they could if they would.

They have no rational evidence to believe, but for them its a faith-based belief. By their numbers they give comfort to the Marks around them.

The\textit{ Promoters }are the ones who keep the bubbles inflated even when they know that the asset exceeds its fundamental value by a large margin. While Shills have no credibility, Promoters have brand-name credibility that makes the Marks trust them. What makes the role of the Promoter egregious is that they are a small subset of the Smart Money. They loudly tell the Marks and Shills that everything is just fine, enticing them to buy into the bubble, even as the Promoters are liquidating their own positions.

Investment banks who sold CDOs (synthetic collateralized debt obligations,) in the financial meltdown and the mortgage lenders in the housing bubble are just two examples. Some investment banks actually bet that the very investments they were selling their customers would fail. Theres a special place in hell waiting for these guys (only because our political and financial regulatory system wont deal with them while theyre on earth.)

To support his position Ben used a quote from Warren Buffett I wish I had found, \textit{The only way you get a bubble is when a very high percentage of the population buys into some originally sound premise...that becomes distorted as time passes and people forget the original sound premise and start focusing solely on the price action...}

The facts that Ben raises, the size and scale of these new markets have never been seen before; some of these applications and companies will reach billions of customers, generate unprecedented revenues and profits, are likely true. But they dont support his justification of the bubble valuations we are seeing for companies filing for IPOs (Pandora Media just priced its IPO at $2.6 billion dollars while admitting it will have operating losses through the end of fiscal 2012.) But to support his position for future valuations Ben lists the low price/earnings ratios of Apple, Amazon, Google, Salesforce.com. He argues that if we are in a bubble these companies ought to have their prices inflated as well.

It turns out that8217s not how a bubble works. Bubbles attract \textit{Marks} and \textit{Shills} to new shiny toys, not existing ones..., Apple, Amazon, et al are not the current objects of desire of this bubble. The question is, are we in a \textit{new }tech bubble? Do the new wave of social/web/mobile/cloud companies going public have valuations which exceeds their fundamental value by a large margin? (today and in the foreseeable future.)

In other words, would you want your mother to buy these stocks to hold them or flip them?

Every bubble is a big-stakes game played for keeps. In it the usual cast of characters appear; the \textit{Smart Money}, the \textit{Shills}, the \textit{Marks} and the \textit{Promoters}.

Theres a saying in Poker, If you cant figure out who the
\textit{Mark}
is at the table, its you.