

CARGO CULTS BY JEREMY WEINSTEIN

RETHINKING THE SILICON VALLEY CARGO CULT

by
Jeremy D. Weinstein

"Cargo cults" are among those oddities of human behavior featured in movies and books that delight in the obscure and bizarre, such as the classic film *Mondo Cane*. During World War Two, as military activity spread throughout the Pacific, native South Sea Islanders watched cargo planes land at airfields hewn in the jungle and disgorge wonderful treasures never seen before, like refrigerators, chocolate, radios and motorcycles, all complete and ready to use. Eventually, the cargo stopped coming, and some natives, not understanding that these consumer goods were end products of a long process of mining, harvest, and manufacture well beyond their capability to duplicate or even understand, sought to enrich themselves by building and ritually maintaining straw planes and runways, sometimes to the exclusion of maintaining their own crops and livestock, with the hope of magically attracting back the cargo planes with their wonderful cargo.

Cargo cult thinking, seeking to satisfy material wants with irrational magic rituals intended to cause the desired objects to arrive from the sky fully formed, is not as far from us as we might smirkingly tell ourselves. In fact, it has over the past couple of years grown to dominate investment psychology in the most technologically advanced corner of the world.

Until quite recently, the public eagerly invested in internet companies brought public without operating profits or even a clear business plan by formerly reputable underwriters who knew a bubble when they saw one. Traditional thinking that a newly public company should grow and innovate and thereby accrete in value was replaced by a mentality that a stock should instantly trade at a valuation that discounted all conceivable, plus ordinarily inconceivable, future earnings. Analysts who should have, and probably did, know better undertook spectacular gyrations to justify

stratospheric stock valuations. Some claimed 200 times earnings could be a fair valuation, because technological innovation would occur in these firms and ownership today on the speculative basis that the cargo of innovation would land there, on that island, was cheaper than to watch for, and then invest in, those companies who did in fact innovate. Even if the cargo can't be seen, the analysts assured the public, it would magically arrive. Even during the biotech stock bubble of the early 1990s, company touts claimed that the companies actually possessed a technology that just needed to be developed and proven

But the public weren't the only ones with the cargo cult mentality. Aeron chairs, already a hackneyed symbol of recent Silicon Valley insanity, represent not just profligacy, but rather companies as cargo, delivered to their private V.C. investors in complete form by magic. I recently upgraded my office furniture to unwrapped, if not used, Aeron and

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CARGO CULTS CONT'D

Teknion chairs that I bought from the empty cubicles of a large dot-com. My firm had a decade of solid profits before I bought thousand dollar chairs for \$300 each. In comparison, the V.C.'s on this dot-com's Board of Directors wanted their company to arrive so successful that it used only the best, before its doors even opened. Instead of husbanding operating cash, they spent \$1,000,000, rather than \$75,000, on chairs. We will likely never learn what would a step up look like for a dot-com that was born as an end-product; the cargo dot-coms with six-figure budgets for what should have been done on paper plates are vanishing fast.

Just as cargo cultists in Vanuatu cleared runways to magically charm the arrival of more cargo planes, private "investors" expected that fully assembled technology companies dropped from the sky, and public "investors" were assured that the magic cargo of wondrous technological innovation would arrive in the stocks they bought. How do we get away from the fallacy that a new company must be cargo under the magic spell of the underwriter's stock analyst, rather than an operating company whose superior management and identified technological edge will grow it to success?

The answer is, maybe we can't. The highly public lottery or gold rush effect of the early internet riches heightened public skepticism of the connection between hard work and material wealth. But a first step could be to recognize this phenomena- that a belief in magic, luck and lotteries has crowded out the Puritan work ethic that built this country, and the prudent, rational investment process that built Silicon Valley over the past few decades. Good technology companies are organic processes that need to be

seeded and grown, they will not succeed as mere commodities to fill a mutual fund manager's fetishistic need for internet companies. V.C.s should invest at levels appropriate for stages of development. In the current tight funding environment, this may start happening again.

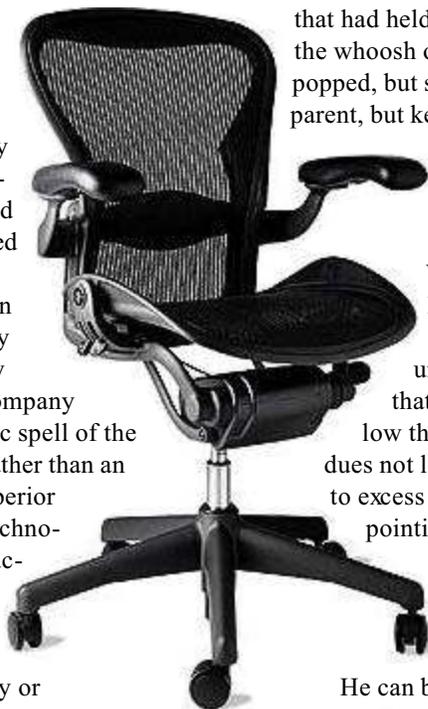
Unfortunately, history has a knack of repeating itself. Some of the same firms that brought the public imploding NASDAQ shares in 2000 brought out 99 to 1 leveraged funds of funds in early Autumn 1929. The "internet frenzy" didn't happen overnight- there was a long run-up to it. After the Gulf War ended, the IPO rush of good companies that had held back going public felt like the whoosh of champagne after the cork popped, but soon the froth became apparent, but kept coming, ultimately culminating in the final excesses of the internet boom.

We can still hope that market discipline and common sense can emerge and triumph for a little while, and that the euphoria sure to follow the end of the current war does not lead us down the same path to excess and an ultimately disappointing dependence on magic.

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