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BEATING UP BIG TECH

In the early days of the Internet, the concept of what can and should be published--and who is responsible for it--troubled authorities. Despite a key 1996 law that seemed to address the issue, more than two decades of explosive growth in the amount of information available online has exacerbated that concern, and prompted new ones. After years of investigations and fines in Europe, America is now the battleground between the "Big Four" Internet platforms (Google, Facebook, Apple, and Amazon) and the government. At issue is, in part, the responsibility each company should shoulder regarding the content published on its sites. More financially important, however, is the question of whether these companies are abusing their power by stifling competition, using their "public" platforms to promote their own products too aggressively, or violating consumer privacy. While it is instructive enough to try to summarize the issues at stake, in the end our concern is whether we can prudently invest in such companies on our clients' behalf.

How It All Began

Way back in the 1990s, as the Internet was only starting to show its promise as a medium for disseminating interesting and useful content, it quickly became clear that public websites were in a precarious position. As offensive content inevitably found its way online, the question arose whether the sites had an obligation to manage it. Section 230 of the Communications Decency Act was intended to provide guidance and legal cover. Under the Act, such interactive computer services were not considered publishers. Therefore, they were not held responsible for the words of third parties who used their sites.

At the same time, the Act encouraged websites to continue developing tools intended to allow users themselves to restrict content (i.e. parental control software) and allowed the sites to remove content they considered offensive. Unsurprisingly, various parties have since taken issue with the law. The crux of the problem is that a website may remove what it considers objectionable content, but cannot be held liable if it fails to do so in a way another party considers "fair." This activity has opened up the Big Four to accusations of bias and negligence, and the suggestion that they should, in fact, be treated as publishers.

Were Congress to make such a change, the Internet could be radically altered. That is, if all web platforms lost Section 230 protection, many might fold before legal action destroyed them. In that case, only the well-funded, i.e. the Big Four and some others, would be left standing. This handful would effectively own the Internet, and adequately managing user-generated content would be extremely expensive, if even possible. As this is such a controversial topic that touches First Amendment rights, for now we place a low probability on its happening, and focus our investment effort on other risks.

Is the Network Flywheel Out of Control?

The issues faced by the Big Four go beyond objectionable content. A fundamental problem is that success in the digital world has turned out to be something of a winner-take-all prospect. The Internet is a network of computers that becomes ever more useful as it establishes more connections to more sources of information. The same goes for a web-based application. It's easy to forget that with the partial exception of Apple, the Big Four are essentially just that, software applications or "apps" (e.g. online search, online shopping, social networking) that became so popular, they started to generate their own gravity. More users made the apps more useful, thereby attracting even more users.

After years of refining its algorithms to provide the best search results, Google's search engine became essentially the only game in town, with more than 92% market share. Facebook is the dominant social network. Because of that, Google and Facebook, which generate most of their revenues from advertising, now generate approximately one third and one fifth, respectively, of all digital advertising revenue in the world. While Apple started as a hardware company, its software created an ecosystem that enabled its App Store to become one of the two dominant marketplaces for mobile apps, along with (surprise!) Google Play. Finally, Amazon generates nearly half of all U.S. retail e-commerce sales.

In the course of becoming dominant, however, each of these companies pursued practices that have since become a source of concern to regulators, technology developers, and consumers. In the last year, American regulators have decided to investigate these practices in depth. Between the Federal Trade Commission, the Department of Justice, the offices of more than thirty state Attorneys General of both political parties, and Senate and House committees, the Big Four legal departments will be earning their bonuses. The first core complaint is that the platform companies became dominant by stifling competition. An example could be Facebook's acquisition of Instagram, which has become a ubiquitous app since its acquisition. For an attorney, this begs the question whether it was the app alone, or its promotion by a larger entity, that made it dominant. If it's the former, regulators may conclude that Facebook saw a threat and decided to eliminate it, which would be a problem.

The second core complaint is that the Big Four have abused their dominant positions by promoting and especially favoring their own products and services. Because most of us are satisfied, possibly even delighted, with the services provided by the Big Four, we may not have a good feel for how they could be abusing their status, but potential examples abound. Amazon is a merchant that sells goods from its own inventory. It also operates an online marketplace where third parties can sell their own products, paying Amazon a commission, and even have Amazon handle the logistics for an additional charge. The problem is that Amazon collects data on what products are most popular, and appears to copy those products and sell them under its own brand. Apple and Google are accused of promoting their own services through the App Store and Google search, respectively. We have no idea whether regulators can prove search algorithms are biased, but a *Wall Street Journal* test over the summer found that Apple's own apps topped App Store search results suspiciously often, especially when the app in question earned money for Apple, and even when its reviews were poor.

The third core complaint relates to consumer privacy. While relevant to us all, we view this as being less a function of the companies' dominance than of poor governance. In other words, it's a risk with all web properties, and not for anti-trust reasons, so it may not be a good reason for a radical penalty. Google was, in fact, fined a very modest amount recently for violating children's privacy rights on its YouTube platform.

Investment Implications

This leads us, of course, to the relevant point. If these companies are all under investigation from various government agencies, what are the risks to them as investments? The Big Four represent nearly one out of every eight dollars of S&P 500 market capitalization, so it behooves us to have an opinion on all of them, regardless of whether or not we own them.

If the end result of the government's efforts is a series of fines and minor behavioral remedies, we are not concerned. Google has already been fined billions of dollars in Europe for anti-competitive practices and breach of antitrust rules. It is the fact that the scrutiny has come to its home jurisdiction that bothers us. As we understand it, American regulators have not historically had a problem with market domination, if it came about naturally and consumers aren't hurt. However, that approach may be giving way in the digital age.

Back in 1998, the DOJ and twenty state Attorneys General sued Microsoft for anticompetitive behavior. The maker of the dominant computer operating system and productivity software suite created its own web browser and integrated it into its operating system, essentially making it free. No consumer can be financially harmed by a free product, but the action destroyed a competitor, and the fear was that it thereby stifled innovation. This is the same issue the Big Four are facing today. In the end, Microsoft settled and was not broken up, but it's very possible that the behavioral remedies that were enforced allowed the rise of Google and a new wave of innovation. Ironically, now that Microsoft again has the world's largest market capitalization at more than $1 trillion, it doesn't seem to be a target.

So, what remedies might be proposed by the government to address today's problems? One is the concept of a "bright line breakup." In this scenario, the Big Four could either operate their platforms or flog their own wares, but not both. This solution seems reasonable, but it concerns us because we believe the practice of doing both has accounted for some of the growth these companies have generated in recent years. Given their other growth characteristics, we view this option as potentially impacting Google and Apple the most.

Another remedy could be to split the Big Four into their original major components. In other words, separate Google and YouTube; and separate Facebook, Instagram, and WhatsApp. We don't see a logical equivalent penalty for Apple or Amazon, and aren't convinced breaking up Google in this way would be value-destructive. We do think it would be problematic for Facebook, however, as we see use of the flagship social network peaking.

A third remedy could be to free up data generated by the Big Four. In a world where artificial intelligence is beginning to permeate more business processes, data are everything to these companies. Big Data are what should enable Google, Facebook, and now Amazon, to target ads effectively. Ads account for approximately 80% of Google's net revenue and nearly 99% of Facebook's, and they are a small but growing portion of Amazon's. Big Data also allow Apple and Amazon to identify successful products and services to offer. If the data were somehow turned into a shared commodity that must be made available to other platforms for a fair price, or reverted to being the property of the consumers by and about whom they were generated, this solution could be the biggest blow to all the companies' business models. And to us, it appears to be the most complicated solution. Perhaps it would change little, since pricing of the data, as well as the accumulated institutional expertise in using it, may mean it continues to reside most effectively with the Big Four.

We at BTR have never been comfortable committing client funds to situations involving binary outcomes, and we cannot at this stage guess what the aftermath of the government investigations will be, though we are aware of the historical difficulty in bringing radical change to technology through anti-trust efforts. Right now, Facebook seems most exposed to this risk. Amazon is attractive as much or more for its cloud services as its retail business, but it currently sports a very high valuation relative to even optimistic growth estimates. Google's and Apple's revenue growth rates could be threatened, but we believe their valuations already reflect at least some of that risk.

MARKET OUTLOOK

Falling interest rates continue to be one of the trickiest situations to manage this year. The extreme downward move in bond rates during August led us to believe that the yield curve may reflect the flight of capital away from trillions of dollars of sovereign debt paying negative interest rates, rather than predict imminent recession in the U.S. In any case, we are inclined to hold more cash than we would normally, as we are sacrificing little, if any, yield.

As for stocks, the S&P 500 index has yet truly to break out beyond the 3,000 level. Corporate earnings growth has slowed, although the vicissitudes of the trade war with China seem to be having less impact on daily trading. The two recent cuts in the Fed funds rate helped to reassure investors of the Federal Reserve's commitment to support the economy. We are not convinced the volatility is behind us, however. Trade talks scheduled for October could bring good news or bad news, and some economic indicators have recently pointed to building risk of a slowdown or possibly even a recession within a couple of years. We therefore continue the process of gradually reducing equity exposure.