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ENTERTAINMENT 2.0

In the past two decades, the Internet has had a radical impact on a number of industries. This year has continued to highlight the already fairly obvious damage to traditional, even iconic, retailers. Our focus for this Investment Strategy Update, however, is on the less obvious conflict in the entertainment industry, where the old guard of well-established content creators and distributors find themselves in a street brawl with a bunch of young and brash – but now also huge and deep-pocketed – companies that have themselves become household names and represent the power of the Internet.

Not in La La Land Anymore

The fundamental building blocks of a good movie have not really changed: good writing, acting, and directing (in short, good story-telling). Practically everything else about the movie business, however, *has* changed: where, how, and which kinds of films are made, as well as how films are marketed, distributed, and viewed.

Digitization and the growth of the Internet have made it feasible to have much of the movie industry maintain headquarters in Southern California while the actual filming, editing, digital effects, or other post-production work can take place virtually anywhere, with constant back-and-forth communication between the people on site and the studio executives "back home." In fact, the majority of computer graphics and special effects work that plays such a major role in many of today's blockbusters is done not in Los Angeles but in Vancouver or London. Now that digital prints have almost completely replaced traditional film, distribution over the Internet has become the norm, which reduces costs, speeds up delivery, and guarantees that the movie will arrive in pristine condition no matter where it is shown and no matter the viewing conditions. Such delivery generates increased demand in more remote areas, and has been positive for studios.

At the same time, these forces of digitization and global distribution via the Internet are lowering the barriers to entry in filmmaking, and thus lessening the control of the major studios over what kinds of movies see the light of day. In essence, cheap but still quite good digital video recording and editing technology, combined with websites like YouTube and Vimeo, mean that any aspiring filmmaker with an idea and a very little bit of money can find an audience. The right content can attract millions of viewers, generating terrific income for those who lack access to the movers and shakers in Hollywood.

Net(flix) Neutrality

High-speed Internet connections, both at home and on the go, have enabled the concept of streaming media, whereby audio and video content is delivered not only to TVs, but also to computers, tablets, smartphones, and even video game consoles. Consumers can therefore access entertainment wherever they happen to be, and, while disruptions or network overloads can sometimes slow or cut off a streaming feed, the idea has nonetheless caught on like wildfire. A recent *Broadcasting & Cable* report noted that 70% of U.S. consumers subscribe to a streaming service and that 40% of all viewed TV content was streamed, twice the level of five years ago. Millennials, who are rapidly becoming the driving force of the economy, stream 60% of all the content they consume. For the first time ever, in 2016 providers of streaming/subscription video on demand ("SVOD") services generated more revenue than DVD and Blu-ray sales combined.

One major enabler of SVOD providers' rise to power is the principle of "Net neutrality," which dictates that all data on the Internet should be treated equally. In other words, network service providers cannot provide a "fast lane" for some types of content. The principle was effectively codified in 2015 when the Federal Communications Commission decided service providers fell under their purview as common carriers (essentially "utilities"), and would henceforth be required to operate in line with Net neutrality.

The most obvious beneficiary of this situation is Netflix, which has played the "disrupter" role in the entertainment business, as Amazon has played it in the retail business. In Act One, Netflix became a major distributor of DVDs by mail, in the process bankrupting Blockbuster and sounding the death knell of the video rental business. In Act Two, and with Net neutrality providing it an equal footing, Netflix changed gears to become a major force in video streaming as movie studios and TV networks eagerly licensed already-existing content for what they viewed as easy money. While the cable and satellite providers had used digital video recorders to allow consumers to escape the limitations of "linear" content viewing, the ability to receive a signal on a wireless device outside the home made content truly "on-demand." Now that Netflix has more than 100 million global subscribers and $11 billion in revenue, Act Three has been to invest aggressively in the creation of original programming, in direct competition with its licensors.

Perhaps the traditional media companies never thought Act Three would or could happen. Unfortunately for them, not only has it happened, but to date, Netflix has also been wildly successful at it. But how? One key reason is that as a subscription service, it has a direct connection with its millions of viewers (something the film studios and TV networks lack). So whenever Netflix decides to buy or create new content it has the benefit of demonstrated viewer preferences on which to base its decisions. This is the fulfillment of the promise of Big Data, and it contrasts with the focus groups, consumer surveys, and gut instincts of traditional media creators. In fact, on the basis of hard data suggesting that it would be successful, Netflix was willing to gamble $100 million on the domestic rights to two seasons, sight unseen, of *House of Cards*. Netflix rocked the boat yet again by releasing an entire season at once, thus making it the first "binge-watch" series. The rest, as they say, is history.

Netflix, by the way, is only one of many challengers to the traditional media companies, and some of these challengers are among the most financially powerful companies in the world. Thanks in large part to the more efficient, data-driven way in which they are making decisions, they are in the position to reduce their financial risk while at the same time offering more favorable terms to writers, producers, and actors, which will, of course, draw more of that talent to them. Unless the major studios and television networks get a lot better at deciding what to produce and how to produce it, they run the risk of losing out to these smart, new competitors. Content may still be king, but having the right sort of content – meaning content that the customer wants to see – makes all the difference. Perhaps scariest of all for traditional media, and as we noted above, not all of the content that becomes popular is even professionally produced.

Investment Implications

Several years ago, we noted a disconnect between advertising spending on certain forms of media and the amount of time people actually spent consuming such media. It informed our decision to approve an Internet company with an advertising business model as an eligible client holding. Since 2005, much traditional media consumption has struggled (radio, magazine, and broadcast TV) or collapsed (newspapers). Because we don't see that trend reversing, companies focused on such media remain of little interest to us.

While cable ad revenue growth is still positive, it has slowed to 1.6% the past few years and it's not looking good going forward, as the total number of pay TV subscribers has fallen by millions from its peak five years ago. Increasing numbers of viewers are dropping their cable/satellite subscriptions entirely ("cord-cutters"), reducing the size of their package ("cord-shavers"), or simply not signing up in the first place ("cord-nevers"). They are, nonetheless, still extensively consuming media. As such, we are focused less on the traditional distributors like broadcast and cable TV companies, and more on those companies that enable à-la-carte consumption of either professional or amateur content, as well as universal access (i.e., wireless infrastructure).

As noted, content is still king. Within the past two months, one of the oldest, largest, and most successful content creators in the entertainment industry suddenly broke ranks with its traditional media peers and announced that it will no longer license content to Netflix. Instead, Disney will create its own streaming services, even though it will mean lost revenues and increased expenses over the next several years. In so doing, it too will establish a direct connection with its consumers and start collecting the same user-based data that is currently unavailable via its traditional means of content distribution: theatrical exhibition, broadcast, and cable TV. We view this as a wise decision to face facts and stay relevant by taking the short-term pain in return for long-term gain.

Because of these new viewing options, the secular trends facing the film exhibition industry – movie theaters – are not ideal, with the latest threat being the possible narrowing of the traditional 90-day exclusive "theatrical window." However, we believe that there will always be a place for movie theatres, as movies remain a basic and still-affordable way to get out of the house. Exhibitors are doing what they can to make the customer experience both enjoyable in its own right and different from watching a movie at home, with reserved, reclining seats, the latest in Dolby surround sound, bigger screens, and better and more extensive concession offerings. For some chains, there continue to be significant expansion opportunities outside the U.S., where theatre attendance remains much lower and where streaming content is less pervasive due to weaker network infrastructure or device penetration.

There are, of course, other areas in which we have interest. Video gaming has become a far more powerful industry in recent years, to the point that professional "e-sports" leagues have been formed, and U.S. males between 18 and 25 prefer watching video game competitions over traditional sporting events. With our focus on the up-and-coming millennial consumer, this is a theme no less obvious to us than the disruption within traditional media. The difficult part for a firm with a conservative investment strategy is to find the right risk/reward trade-off, so for the moment, our interest in gaming, as well as in some of the more speculatively-priced disruptors, remains largely academic.

Market Outlook

Globally, both developed and emerging economies are growing in tandem, providing a favorable backdrop for manufacturing, trade, employment, and investment. Our expectation is for a continuation of this trend with limited inflationary pressure for now.

The U.S. economy continues to expand at a sustainable rate. While we expect GDP growth in Texas and Florida to have been stunted temporarily by the impact of Hurricanes Harvey and Irma, the massive rebuilding process over the coming months will provide economic stimulus as stores, factories, and refineries come back on-line. Meanwhile, domestic consumer confidence readings are at multi-year highs, corporate profit margins are at record levels, and a relatively cheap dollar will provide support for U.S. exports. All of this should be supportive of the equity market going forward.

At the recent Federal Reserve meeting, members voted to begin the process of reducing the size of the Fed's $4.5 trillion bond portfolio. While the initial reaction in the bond market was fairly muted, we are not certain that markets will remain quiescent. There is no historical precedent of this scope and magnitude by which to estimate its impact on interest rates, currency values, and asset prices.

Despite the overall positive environment, with the ongoing geopolitical tensions, equity valuations above their long-term averages, and the prospect of further increases in interest rates over the next year, including at the December Fed meeting, we are maintaining a cautious approach in our asset allocation and security selection.