2020 1st Quarter Stock Market Commentary

THE MYTH OF FREE MARKETS

"The only mystery in life is why the
kamikaze pilots wore helmets."
– Al McGuire

In 1970 Swedish economist Staffan Burenstam Linder published a fascinating book entitled *The Harried Leisure Class*. Linder sought to understand the conundrum of why rising incomes did not seem to produce greater happiness. After all, people at the time had a longer life expectancy than any previous generation, worked a shorter work-week, and had the benefit of labor-saving devices like washing machines, vacuum cleaners and dishwashers. So why were so many so miserable?

Linder's surprising answer was that the cornucopia of consumer goods exacts a tax on the scarcest of all resources – time. With dozens of different cars to choose from, hundreds of clothing manufacturers and thousands of different wines, any individual who wants to spend the hours required to educate herself to become an expert consumer will have little time left to either earn an income or enjoy the purchases. Adding insult to injury, few of the purchases work as advertised, requiring time to wait for one of a dwindling supply of servicemen, or worse yet, becoming a do-it-yourself (and hence inefficient) repairman. Linder basically questioned one of the axioms of American capitalism, that growth is always preferred to stasis.

Another axiom is that free-market capitalism, as implemented in the United States, produces the most robust competitive environment. But does it?

In the half century since the appearance of this entertaining book (yes, an economics book can be entertaining) capitalism as practiced in the United States has undergone a radical change. Where once there were dozens of competitors in certain key sectors, consolidations, bankruptcies and lax anti-trust enforcement have reduced that number to a handful.

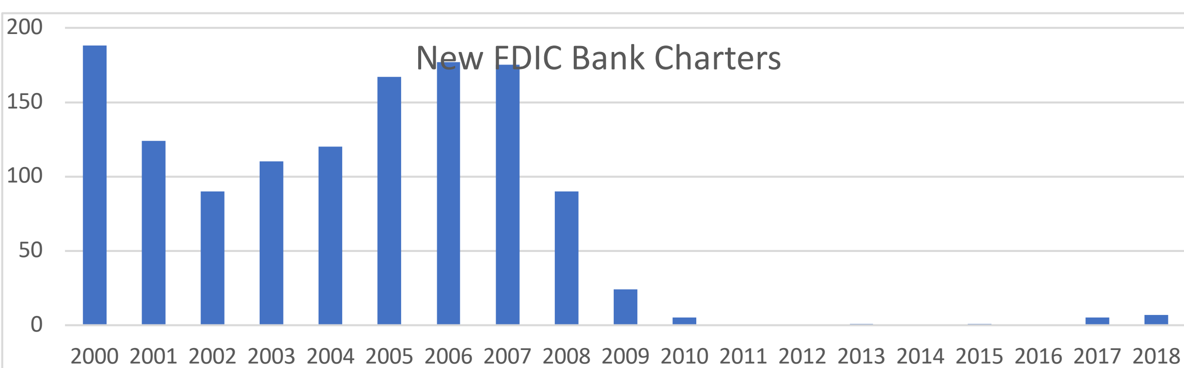
Consider the cellular phone service industry. In the United States, there are essentially three service providers for a country of roughly 330 million people: Verizon, AT&T and the newly combined T-Mobile/Sprint. In the United Kingdom, whose population is approximately 66 million 20% that of the U.S.), there are four main providers. Each of them is required by law to lease their networks to their competitors at cost. In the U.S., regulators have imposed no such requirement, creating a formidable barrier against upstarts. As a result, according to a study by the Open Technology Institute, a typical cell phone plan offered by Verizon that includes voice, data and text, costs a whopping 61% more than a comparable plan offered in Britain from provider Three UK. The minimum cost of a bare-bones package costs 85% more in the U.S.

The situation in France is even more dramatic. The population of France is almost identical to that of Great Britain, and for the first ten years of mobile service there were three providers who benefited from oligopoly pricing. But in 2011 regulators in France decided to grant a license to a new entrant, Free. In its first three months of operation the company achieved a 4% market share, and the three legacy carriers were forced to lower prices somewhat. At the end of its first year, Free's market share had risen to 12%, and it currently is 15-16%. Encouraged by this example, other competitors soon appeared, so that France now has ten different mobile operators to serve a country one-fifth the size of the U.S. Not surprisingly, the cost of cell phone service has plummeted 80% in the last decade.

Over the next decade it is estimated that American consumers will overpay by a quarter of a trillion dollars to receive worse service than what is available in most other developed nations.

A similar situation has occurred in the banking sector. In 1970 there were 13,511 commercial banks in the United States. By last year that number had shrunk to 4,718, a 65% decline. But not only have the number of banks declined, the percentage of the market controlled by the largest banks has soared. Twenty-five years ago small banks (under $1.2 billion), medium-sized banks ($1.2-10.2 billion), large banks ($10.2-100.2 billion) and giant banks (over $100.2 billion) had roughly equal market share. The share of deposits at giant banks has now soared to 59%, and the four largest banks - Bank of America, Citigroup, JP Morgan Chase and Wells Fargo - control 36%.

It is unlikely this trend will be reversed anytime soon since the number of new bank charters has fallen nearly to zero. Post the 2009 financial crisis the cost of regulatory compliance has soared. JP Morgan Chase, for example employs 30,000 compliance officers, a staggering number. Further, capital requirements have been raised. How can a start-up compete? The chart below shows the number of new FDIC charters every year from 2000-2018.



Not surprisingly, the shrinkage in competition has coincided with a sharp rise in the costs charged to consumers for bank services. For example, the average fee to use a non-network ATM has risen every year for fourteen years, and is up 53% in the last decade. CBS News recently reported that bank overdraft fees have also climbed to a record high. Just as in telecom, industry consolidation has resulted in an oligopoly, which in turn has led to higher costs for consumers.

But the greatest "monopolization" has undoubtedly occurred among big tech companies. Google, for example, performs a whopping 73.3% of all online searches. It is so ubiquitous that "to google" has become a verb. When was the last time you tried to find something using AskJeeves, Yahoo, Bing, Yandex or DuckDuckGo (yes, these are all real search engines)? This dominance has resulted in Google parent Alphabet earning 32.3% of total world-wide digital ad revenue and 56.6% of mobile ad revenue. In Europe, regulators filed charges against Google three times in as many years. Ultimately, they found the company guilty of tweaking its search algorithms to exclude competitors' products from the first few pages of searches and fined them more than $9 billion.

Similarly, Facebook, which dominates social media platforms, controls 31.0% of total world-wide digital ad revenue, with nearly 90% of that coming from mobile. It has been cited by a coalition of state attorneys general for mishandling consumer data and reducing consumer choice.

And then of course, there is the behemoth Amazon. In 2019 it accounted for 45% of total e-commerce retail sales, and its share is forecast to hit 47% this year and 50% in 2021. It has been accused of making it hard to find and buy products of vendors who offer their products at lower prices on other websites. In 2014 Amazon was in a dispute with publishing company Hachette over the pricing of e-books for the Amazon's Kindle. While the dispute was ongoing Amazon blocked pre-orders for upcoming books from Hachette.

Despite the examples cited of anticompetitive behavior cited above, these companies do not meet the generally accepted criteria for being deemed a monopoly in the United States. The standard for judging whether a company has been guilty of misusing its market dominance has not been size or market share, but rather whether their behavior has resulted in higher prices for consumers. Antitrust enforcement in this country has been lax at best. For twenty-five years, from 1970 to 1995, the Justice Department filed an average of nearly 16 antitrust cases per year, culminating in a case against Microsoft. But that was the last major case filed by the government, and in the subsequent twenty-five years there have been less than three minor cases per year.

If left unchecked, it seems obvious that the market power of these companies will only grow. According to data from Bloomberg (the company, not the recent Presidential candidate), over the past decade Alphabet, Amazon, Apple, Facebook and Microsoft have made 431 acquisitions for more than $155 billion. The companies simply snap-up nascent threats, in the way that Facebook bought Instagram and WhatsApp, and Google bought DoubleClick and YouTube.

But political pressure is growing to modify existing antitrust regulation to permit the government to rein in these monopolies. Both the Justice Department and the Federal Trade Commission, as well as several attorneys general, are reviewing their business practices. President Trump has railed against these companies, saying "obviously there is something going on in terms of monopoly." Joe Biden has slammed big tech, and both Elizabeth Warren and Bernie Sanders have called for breaking up the largest technology companies. The fact that there are critics on both sides of the aisle, suggests that there may be bipartisan support for a new approach to antitrust enforcement.

What might new legislation look like? First, it might eliminate the requirement that monopolists be shown to raise consumer prices. After all, dominant technology companies, like Amazon, can price selected products below cost for years, and subsidize the loss by discriminating against some categories of consumers (a policy known as "recoupment"). Some observers feel that below cost pricing should automatically be deemed anti-competitive.

Second, there is a proposal for enhanced review of proposed mergers, to prevent companies like Facebook from acquiring upstart competitors. Frequently, promising technology start-ups are too small to trigger FTC or DOJ review under Hart-Scott-Rodino.

Third, impose government review of product design decisions, with an eye towards eliminating exclusionary designs. For example, should Apple be able to bar downloading apps from anywhere other than its App Store?

Finally, some legislators have proposed breaking up the big tech companies. The consequences for investors depend very much on the final form of any legislation. For example, a break up might very well create shareholder value. As we are writing, Alphabet is trading at roughly $1,160 per share. We have done a break-up analysis of the company which values the sum of its parts at $1,650-$1,850. But other proposals, like requiring product design review, would sharply reduce future earnings prospects. How much less would Facebook be worth if the data it collects belonged to the consumer, so that it could be ported to anther platform? Facebook's ability to monetize its vast trove of information would be sharply curtailed. If consumers could download apps to their iPhones from third party vendors, what would happen to the value of Apple's service revenues?

Something is likely to happen, but it is far too soon to predict the shape of new regulation. But investors would be well advised to monitor proposals, since they could sharply change the value of some of individual investors' favorite holdings.