2018 3rd Quarter Stock Market Commentary

THE NEW MONOPOLISTS

"I think it is wrong that only one company makes the game monopoly."
- Steven Wright

In 1926 entrepreneur William Black opened a nut store in Times Square. He soon expanded to a chain of 18 stores but fell upon hard times when the Great Depression hit and people could no longer afford the luxury of shelled nuts. So Black converted his stores to coffee shops selling sandwiches and a cup of coffee. The shops are long gone, but the coffee brand he created lives on as Chock full o'Nuts. Most baby boomers can still recall their jingle, "Chock full o'Nuts is that heavenly coffee … better coffee a Rockefeller's money can't buy."

So how rich was John D. Rockefeller that his name became an exemplar for being rich? The answer is V-E-R-Y. In a 1902 audit his net worth was estimated at $200 million (it was $1.4 billion at his death in 1937). At the time of the audit, the total gross domestic product (GDP) of the United States was roughly $2.4 billion, meaning that he was worth 8% of the nation's total output of goods and services. To put this in perspective, current GDP is $19.4 trillion, meaning that to be proportionately rich would require a net worth of $1.5 trillion. That's five times the net worth of Jeff Bezos, Bill Gates and Warren Buffett combined.

Rockefeller's wealth derived from the Standard Oil Trust. The trust was a form of business in which one company owned other companies, what we would today call a holding company. At its peak, Standard Oil controlled 87% of the oil industry in the United States. It had put almost all of its competitors out of business through monopolistic business practices, although the public often benefitted from lower prices and reduced pollution. The passage of the Sherman Act in 1890, designed to curb such practices, gave the government a potent weapon. Five years of litigation from 1906-1911 resulted in the breakup of Standard Oil into thirty-six separate companies, among them Standard Oil of New Jersey (which became Exxon), Standard Oil of New York (Mobil), Standard Oil of California (Chevron) and Standard Oil of Indiana (Amoco).

Over the past century the government has successfully broken up companies that dominated the tobacco industry, meatpacking and the railroads, among others. In 1982 the government forced the breakup of AT&T. For decades, AT&T had refused to allow smaller telephone companies to connect to its network. It further refused to allow the use of telephones not manufactured by its Western Electric subsidiary. The government permitted this behavior in exchange for a promise of universal service, even in rural areas, as well as a commitment not to compete in computers. But eventually both sides chafed at this situation, and a January 8, 1982 consent decree resulted in the divestiture of the seven Baby Bells which provided local telephone service, with AT&T keeping the long-distance business and yellow pages. This action now seems somewhat quaint, given how mobile telephony has eliminated the distinction between local and long distance, and the internet has obviated the need for printed phone books.

Given the zeal with which the government has attacked monopolists over the past century, it is remarkable that there has not been more talk about breaking-up, or at least more strictly regulating, today's monopolists: Facebook, Google (now called Alphabet), and Amazon.

Consider first Facebook. Fully 95% of young adults who have access to the internet have a Facebook account. Worldwide, there are roughly 2.3 billion users. Facebook's social network advertising revenue for the past three years has been more than 75% of the total advertising revenue on all social networks combined. Facebook and Google combined receive two thirds of all internet advertising dollars, and account for essentially all growth in that revenue stream. Of the ten most popular free apps available, three are owned by Facebook: the basic Facebook app, Instagram and Messenger. A fourth Facebook subsidiary, WhatsApp, is at number 12.
But size alone is not a reason to consider antitrust action against a company. In many respects size is simply the best measure of a company's success at delivering a product or service its customers want.

But it is the use (or abuse) of that size which can create a problem. As an example, the Federal Cartel Office in Germany (an analog of our Federal Trade Commission) recently revealed that Facebook, Germany's dominant social network, gathers data on which other web sites its users visit and doesn't ask for consent as to how that data is used. People only have the choice to accept the entire package or stop using the network, it said, attacking "inappropriate" terms of service widely used by internet sites.

Consider that revelation in light of research by Facebook's own data scientists, who found that they can influence voter turnout merely by showing that their friends are voting. What is to stop a partisan Facebook executive from sending such a notice only to liberal leaning users (determined via information gathered from other website searches), resulting in increased voter turnout among left-leaning voters? French officials have similarly criticized Facebook for merging data about its users with its messaging app WhatsApp without their knowledge or consent. Officials have given the company one month to cease this activity.

During Mark Zuckerberg's Congressional testimony, he repeatedly claimed that Facebook users own and control their own data. Yet Facebook has repeatedly cut off competitors, like Twitter, Vine, MessageMe and Voxer from its feature for finding your Facebook friends on their apps. In 2010 Facebook encouraged its users to upload their contact list from their Gmail accounts. But it refuses to let users export those same email addresses to other apps, including those operated by Google. When not offering testimony, Facebook behaves very much like it, not you, owns your data.

The case that Google is a monopolist is even stronger. It is estimated that Google processes 90% of internet searches world-wide. It handles approximately 5.5 billion searches per day, or an astonishing 63,000 searches per second! Its tentacles extend into a vast array of other industries:

the YouTube website is a ubiquitous video sharing website, Nest Labs produces internet enabled thermostats, smoke detectors and security systems, Waymo is Google's self-driving car project, and Calico is a biotech research and development company struggling to treat problems associated with ageing, to name but a few. But despite its ambitions, fully 90% of its revenues come from ads placed through its primary search product.

And therein lies the problem. European regulators have brought a series of charges against Google for anti-trust behavior which resulted in a $2.3 billion fine. There were three basic claims.

First, Google favors its own comparison-shopping service in its search results. The New York Times recently published a story about a British couple, both computer scientists, who developed a vertical search algorithm named Foundem.com which consistently delivered superior results to Google Shopping. Within two days of going live with their product, web traffic dropped to near zero when Google moved them to page 15 when searching for a price comparison tool. Similar charges have been filed with the Federal Trade Commission by Yelp and TripAdvisor, among others.

Second, Google has been accused of abusing the dominant position of its Android operating system for mobile phones. This operating system is provided to phone manufacturers like Samsung for free, provided they agree to pre-install Google's Chrome internet browser and Google Maps app. This business practice is known as tying, and even though it may result in lower consumer prices it is viewed as evidence of monopolistic behavior. It is the same strategy that Microsoft employed when it bundled its Internet Explorer web browser with its Windows operating system, sounding the death knell for companies like Netscape, and prompting an antitrust suit by the government.

Third, Alphabet has restricted third-party websites that wish to use its AdSense for Search platform from displaying search ads from Google's competitors, and has insisted that it will not place ads on third-party sites unless they reserve the most prominent space on their web pages for Google ads. This restraint of trade activity is made possible by their dominant position in internet advertising.

The last member of our monopolist triumvirate is Amazon, the e-commerce retailer and web services provider. From its inception as an online book retailer, it has become the largest internet retailer in the world, selling nearly every category of goods (although I do not believe they sell live pets, only pet supplies), as well as proprietary products like Echo, Fire tablets and Kindle e-readers. It is so dominant, that its annual sales are roughly equal to the total of all other e-commerce retailers combined. It has crippled the businesses of such iconic retailers as Macy's, Foot Locker and Costco, while simultaneously encroaching on recent start-ups like ready to eat meal kit maker Blue Apron and crafts seller Etsy. Stock prices of entire ancillary industries have come under pressure each time Amazon makes an announcement that it entering their space – talk of Amazon building its own freight network has prompted selling of UPS and FedEx, the acquisition of Whole Foods threatens the entire grocery industry, and talk of online pharmaceutical sales has pummeled the shares of drug distributors Cardinal Health, McKesson and AmerisourceBergen.

Undoubtedly, Amazon's success has come from outcompeting its rivals. But the methods it uses now that it has achieved this massive scale are questionable. First of all, Amazon makes no money on its retail operations. It loses as much money on its international sales as it makes on those in the U.S. In 2017, 100% of its operating cash flows came from Amazon Web Services, which permitted it to employ predatory pricing. (That percentage is down to below 80% since the acquisition of Whole Foods.)

Second, Amazon serves as a marketplace for third-party sellers. With each transaction, though, it uses its big-data prowess to gather information about those sellers' customers, eventually undermining them as competitors. A well-known example of this is detailed in the book *The Everything Store: Jeff Bezos and the Age of Amazon* by Brad Stone. Amazon maintains a little known unit called Competitive Intelligence, tasked with studying competitive threats. In the early 2000s the unit became aware of a rapidly growing on-line retailer, Diapers.com, a subsidiary of parent company Quidsi. Amazon offered to purchase Quidsi several times at a price in the billions of dollars, but was rebuffed. Soon after, Amazon slashed prices on diapers and other baby products by 30%. Each time Quidsi tried to adjust its prices Amazon's pricing bot responded with further cuts, slamming the brakes on Quidsi's growth. In 2010 Amazon acquired Quidsi for a fraction of what it had offered originally.

It seems clear that Facebook, Google and Amazon are effectively monopolies. But it is equally clear that existing antitrust laws were not written to deal with internet-based companies which benefit from a network effect. Historically, antitrust enforcement has focused on harm to the consumer, usually in the form of excessive prices. But in the case of Facebook and Google, their service is provided for free (unless you consider the information users supply as a form of payment), while Amazon has driven prices lower for almost all consumer goods. In a recent Yale Law Journal article *Amazon's Antitrust Paradox*, author Lina Khan, the director of legal policy at the Open Markets Institute, argues that Facebook, Google and Amazon enjoy systematic advantages that allow them to extract for themselves the returns of other businesses. She thinks such companies should not be able to compete directly with other companies on their platforms. Thus Amazon, in her opinion, should be able to sell its own merchandise, or be a marketplace for third-party sellers, but not both. Facebook should be allowed to enjoy its success as the dominant social media platform, but should not be able to own Instagram to compete against Snapchat. Google should not be able to give preferential placement to products it produces.

Not surprisingly, libertarians reject such interference in the market place, arguing that it is simply motivated by envy of success. But it seems to me that some reworking of centuries old antitrust law is inevitable, lest these monopolies suffocate the very entrepreneurial enterprises that allowed them to thrive in the first place.