INVESTMENT STRATEGIES

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Are the Winds of Antitrust Changing?

Considerations if rumblings turn into concrete action

On June 27th, 2017, the European Union leveled the largest antitrust fine ever ($2.7 billion) against Alphabet's (GOOGL-$940.08) Google, claiming the company discouraged competition and harmed consumer choice by elevating its shopping platform over its peers. Less than two weeks later, the News Media Alliance proposed a safe harbor from antitrust law to allow publishers to negotiate collectively against "Google and Facebook's (FB-$171.18) duopolistic dominance of online advertising." Days later, *The Wall Street Journal*, a member of the News Media Alliance, published a lengthy article about Google's secretive financing of research papers to help defend it against antitrust regulatory challenges, among other issues. All the while Amazon (AMZN-$982.01) destroys billions in market capitalization by announcing it is merely *considering* entering a new business.

This series of events could be a coincidence, but investors should always take a second look at supposed coincidences. We don't wish to alarm tech investors with this specific news flow. Old industries are vulnerable to antitrust challenges as well, and the Democratic Party's "Better Deal" platform, which attacked cable providers and airlines, is yet another example of news that suggests the winds of antitrust could be changing. The new agenda was released on July 24th and emphasized antitrust action and combatting the concentration of economic power. While Democrats are currently a minority party in Congress, this could change with Republicans failing to capitalize on big agenda items thus far.

For now, it remains to be seen if Republicans in Congress will even consider a more vigorous antitrust push. While historically opposed to antitrust enforcement, a dramatic decline in small business starts and the disappearance of mom-and-pop shops in small communities that often comprise their political base may push some Republicans to reconsider. We typically prefer to refrain from political speculation, but we suspect the Trump administration will not take up the sword on an antitrust agenda. As such, this writing is more of a preparation exercise than an actionable recommendation.

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If the changing winds turn into gusts, investors must ask if it is simply hot air from politicians or a legitimate concern. We believe there is strong evidence of significant consolidation in the economy. According to the US Census Bureau, ten of the fourteen industries listed experienced an increase in market concentration from 1997-2012 as measured by the revenue captured by the top 50 firms. Over the same time frame, the Herfindahl-Hirschman Index (a measure of concentration) of publicly traded companies increased by roughly 50%. Meanwhile, the percent of new firms relative to total firms, which historically oscillated around 10%, now sits at 7.8%. The number of nonfarm self-employed workers is roughly flat from 1990 despite a ~29% increase in the population.

The reasons for the increasing concentration and decline in startups are numerous and go beyond a simple antitrust enforcement argument, in our opinion. However, it is worth noting that, with the exception of a bump in the late 1990s, the number of civil antitrust lawsuits (those challenging M&A) has been in decline since the late 1970s.

The question for investors is whether lawmakers use deregulation -- to lower business costs and therefore barriers to entry, which in turn allows more entrepreneurs to challenge incumbents and create a more dynamic economy -- or use the blunt instrument of antitrust law. From a macro perspective, the former should boost growth and wages given the powerful punch small businesses pack in terms of adding new jobs and increasing competition for workers.

A follow up question is whether voters and lawmakers have the patience to allow the impact of deregulation to bear fruit, given that it could be years before the effects are obvious. We suspect the answer is no, so investors should still consider the investment ramifications of antitrust action.

We turn to the history book for a lesson in investing during an antitrust wave. We believe the dynamics of today's economy are similar to the situation in the aftermath of the American industrial revolution. Throughout the industrial revolution, new jobs were created in industry, and agricultural employment shrank. As more and more innovations continued into the early 20th century, industries such as steel and oil were revolutionized, and dominant businesses arose. The titans of these new industries amassed huge market shares through a variety of methods and attained enormous wealth.

According to data from the National Bureau of Economic Research, the top 0.1% held about 22-23% of total household wealth in 1913, roughly the same as 2013. Investors should recognize the tune.

We can't pretend to know what industries may be targeted by tomorrow's politicians. Thus, to gauge the investment implications of antitrust action, it is important for investors to consider how an oligopoly/monopoly came about and the sentiment of consumers regarding these companies. Those companies such as US Steel (X-$24.08) in the early 1900s were created through mergers and acquisitions.

Further, U.S. Steel's president Elbert Gary organized famous "Gary dinners" with peers to fix prices. Therefore, steel customers were generally unhappy and not benefitting from the consolidation. Although US Steel managed to avoid government action, its lazy practices allowed competitors to take market share, with US Steel slipping from 67% of the market in 1901 to 50% in 1911. During that time frame, metal prices were roughly flat. However, as US Steel slipped further, increasing competition led metal prices to decrease dramatically.

On the other hand, Standard Oil made acquisitions, including vertically, but it was John Rockefeller's laser sharp focus on costs and operations that allowed Standard to drastically undercut competition on price. After Standard was broken up in 1911, oil prices almost doubled despite increasing production until a recession in 1920. Thus, the Standard monopoly was mostly a result of sheer ability and resulted in happy, well-supplied consumers.

In essence, investors may wish to capitalize on stocks driven down by antitrust fears or actions if the targeted company has achieved its status through innovation and motivation for customer satisfaction – Standard Oil's 34 successor companies proved to be more valuable than the whole. On the other hand, companies that achieved dominance through brute M&A and fail to satisfy customers with price and/or service may not be attractive investments -- US Steel bled market share for years.

Of course, each situation is different so sound research and analysis is critical, and that leads us to our next point. We believe, whether the chosen route to deconsolidate the economy is deregulation or antitrust, stock picking will become even more important. Especially in low growth industries, we expect those investing in the weaker operators will not be bailed out by M&A. Choosing the right management team with the right strategy at an attractive price will be rewarded with even greater outperformance, in our view.

Additional information is available upon request.

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Hold/Neutral	77	61%	8%	92%
Sell	11	9%	0%	100%

As of 9 August 2017

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