Second Quarter Review

	Close 6/30/17	Total Returns 2nd Quarter	Total Returns 2017 Year-to-Date
Standard & Poor's 500 Index	**2,423**	**+3.09%**	**+9.34%**
Dow Jones Industrial Average	**21,349**	**+3.32%**	**+8.03%**
NASDAQ Composite Index	**6,140**	**+4.16%**	**+14.71%**
Dow Jones Global (ex U.S.)	**240**	**+4.85%**	**+12.62%**
Barclays Aggregate Bond Index (BNDS)	**1,921**	**+1.45%**	**+2.27%**

Consumer Technology's "Big Five"

Investors love consumer technology companies. The five most highly valued companies in today's stock market are Apple, Alphabet (aka Google), Microsoft, Amazon, and Facebook. They are the "Big Five," or the "Frightful Five" to their critics. Most Americans use their services or products every day, if not every waking hour. Years ago the most successful technology companies, such as Cisco and Oracle, sold expensive productivity-enhancing hardware and software to large institutions around the world. The new technology leaders, in contrast, are focused on "consumer engagement", loosely translated as making their products as addictive as possible to the general public. They provide products and services that enable individuals to send photos to friends, order a car service, listen to music, watch filmed entertainment, shop for bargains, email colleagues, check news headlines, set up dates, and so on.

The growth in the internet, mobile phones, and applications has been a major factor for these companies. In a little more than 15 years internet users have grown from less than 500 million to approximately 4 billion. Mobile phones have grown from 1 billion to 2 billion in just the last five years. The consumer market is much bigger than the one that the old technology favorites targeted.

"The digital economy is an economy in which platforms are the biggest source of value," writes James Surowiecki in the current issue of MIT Technology Review, "and the Big Five's platforms are the most lucrative ever invented….The Big Five sometimes compete and sometimes cooperate, but ultimately each has solid control over its core markets." There are many explanations for the success of this "Big Five."

- Some cite the "network effect," which means the more people who use a service the more valuable it becomes. When Facebook refers to its huge and growing base of monthly users, they are in effect telling investors how much stronger their network is.
- Another reason mentioned for their dominance is that they have more data on their customers, which enables them to provide more relevant information, products, and services.
- Others highlight the brilliance of their founders to create such profitable businesses that can financially outmuscle weaker competitors.

In other words, it is a winner take all world, or in Google's and Facebook's case, about 90% of all on-line advertising.

This success has not gone unnoticed by some anti-trust authorities around the world. And, it may be the courts that are the major impediment to their continued dominance. Microsoft spent over 20 years battling U.S. antitrust pressures. Google escaped U.S. antitrust penalties several years ago by agreeing to certain operating changes. However, the European Union recently fined Google $2.7 billion on antitrust grounds because the company denied "consumers a genuine choice" by using its search results to steer consumers to their own shopping platform. Google once again will be forced to make concessions in how they operate. Clearly, competitors to the "Big Five" have found the going tough, but it would be difficult to prove that consumers have suffered -- an important litmus test for U.S. antitrust violations. Amazon, however, may be the most likely candidate of the "Big Five" to ultimately contend with antitrust issues at home.

In this January's Yale Law Journal, attorney Lina Khan lays out the case for how antitrust laws should change in the internet world of companies like Amazon. Her conclusion is that "internet platforms mediate a large and growing share of our commerce and communications. Yet evidence shows that competition in platform markets is flagging, with sectors coalescing around one or two giants. The titan in e-commerce is Amazon -- a company that has built its dominance through aggressively pursuing growth at the expense of profits and that has integrated across many related lines of business. As a result, the company has positioned itself at the center of internet commerce and serves as essential infrastructure for a host of other businesses that now depend on it." She goes on to argue that Amazon's business strategies and current market dominance pose concerns that the consumer welfare framework in U.S. antitrust laws fails to recognize.

We do not discount the antitrust risk for Amazon, but it is likely to be a longer term potential problem at best. In the meantime, Jeff Bezos, the founder and leader of Amazon, has created and managed an internet juggernaut. Mr. Bezos simply bet the ranch on the growth potential of online shopping and built an expensive infrastructure that no competitor was willing to match. Amazon's online marketplace sells a vast selection of goods at low prices combined with the instant gratification of fast delivery. "Amazon is the best, without any comparison, transaction platform in the world," stated Adidas Chief Executive Officer Kasper Rorsted. "I feel like Amazon is just the go-to" stated shopper Julie Wyatt in a recent Wall Street Journal article, "It's just so much more convenient." So with antitrust concerns in the distant background and the strength of the platform without question, how should an investor view Amazon?

"If everyone does their shopping online, the malls will close and we won't have anywhere to hang out."

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First of all, it has clearly paid off to stay out of Amazon's sights. Stocks of numerous competitors, particularly brick and mortar retailers, have been slammed. Some have gone bankrupt and others have put themselves up for sale. Buyers are not to be seen. Even the possibility of facing Amazon as a competitor has caused stocks to decline. When Amazon and Whole Foods recently announced that they were going to merge, supermarket stocks as well as food manufacturers declined significantly in value. A simple rumor of Amazon entering the drug store business sent the shares of Walgreens and CVS tumbling. Best Buy recently tanked when investors heard that Amazon was forming its own "geek" squad. Auto part retailers have been pummeled as well by the competitive threat of Amazon.

Secondly, it is important to emphasize that the strength of Amazon and the "Big Five" platforms are largely driven by consumer continued interest and satisfaction. Consumers can be fickle, particularly in this age of social media. They can turn on a company in a second. Just ask Uber. But consumers can also become addicted to a product or service, which can overwhelm their fickle gene. A survey conducted by Common Sense Media found that 60% of adults feel they are addicted to their mobile devices. Some 72% of teens said they needed to immediately respond to texts and social networking messages. Consumers are wired to this new technology wherever they go. Mobile phones have become bodily appendages -- they are used every minute without embarrassment -- elevators, bathrooms, ballfields, movie theaters, and so on. There are estimates that most "smartphone" users check their phones 150 times a day. Score one for the addicted, zero for the fickle.

When Warren Buffett was asked why he had not owned Amazon stock, his reply was "I don't have a good answer." He went on to say, in effect, he did not understand the power of the model and the stock price always seemed to reflect the model. In order to have invested in Amazon during their formative years of massive losses, an investor would have needed to be convinced that shoppers' habits would change before Amazon ran out of money. Actually, either through luck or great foresight, Amazon developed a secret profit generating weapon called the cloud business. This traditional, old era concept of providing data management services to business clients turned their financial reports from red to black a few years ago.

Unlike their merchandise offerings, Amazon's stock is hardly valued at a bargain price. It currently is selling for 85 times next year's estimated earnings reflecting the rapid earnings growth expected over the next two years when earnings more than double. Amazon has been the biggest winner of the "Big Five" over the past several years. Investors expect Amazon's popularity, usage, and dominance to continue to grow rapidly and for a longer period of time. Alphabet, Facebook, and Microsoft are all selling in a range of 20 to 25 times next year's earnings, more reasonable in light of their earnings growth. Apple appears the cheapest on a price-to-earnings basis selling at 14 times next year's earnings. Investors are obviously less confident in Apple's ability to continually introduce new products and services that capture the imagination and wallets of consumers.

The "Big Five" are a remarkable group of young companies. In a slow growth economy they have stood out as a handful of large companies with strong growth and open-ended opportunities ahead. The youngest two companies, Google and Facebook, have produced tremendous revenue and earnings growth. It is fair to question whether we are about to experience a replay of the late 1990s and early 2000s when technology stocks turned from favorites to pariahs. Barring a market collapse, we do not think so. We are suspicious, however, that they will continue to race ahead at the current pace.

Financial Market Thoughts

The market continues to be void of volatility and so far the performance of the S&P 500 Index this year has exceeded our expectations. One plausible explanation is that intermediate interest rates, such as the ten year Treasury bond, have declined rather than increased, as most forecasters projected at the start of the year. The decline in yields may be attributed to the weakness in oil prices combined with the lack of progress on any economic stimulus legislation, such as tax cuts or infrastructure spending. Although central banks are moving to a less accommodative strategy, the stock markets appear unconvinced that rates will move considerably higher.

Another noneconomic factor that may be boosting prices and market valuations is the continued trend of large money flows into so-called passive stock funds (for more on our view of the passive versus active discussion, please see our website). When a market is in its ninth straight year of positive gains, and there is very little volatility in the market, investors are rewarded by continuing to shovel money into the stock market. Just as the industrial behaviorists within the "Big Five"

understand how to develop Pavlovian clicking/tapping behavior, "click bait," when investors are rewarded by daily increases in their stocks, they, for better or worse, buy more. Stock investors can be conditioned by low volatility and ever higher prices as well.

Enjoy the Summer!

Bob Milnamow
President and
Chief Investment Officer
July 2017

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