RBC Global Asset Management

Safeguarding Competition:
Laws and politics in a globalised world

RBC GAM European Equity team

"In general, if any branch of trade, or any division of labour, be advantageous to the public, the freer and more general the competition, it will always be the more so" – Adam Smith, The Wealth of Nations, 1776

As investors, we spend the majority of our time analysing companies that compound economic value. A company that is able to generate sizeable profits, sustainably, over a period of time, is often attractive from an investment perspective, but what allows a company to earn money over and above its cost of capital? And more importantly: what allows that to remain the case for years, often decades? Economic theory dictates that an industry where supernormal profits can be earned becomes vulnerable to new entrants. Therefore, these profits will be eroded by competition over time.

This has certainly been the case throughout history. Nokia is a prime example: previously dominant in the mobile phone industry for several decades, new entrants came in with innovative functionalities and made its technology redundant.

It's not that simple though. There are numerous cases where this does not happen, yet companies have continued to generate very good returns on capital over time. Due to the nature of compounding - dubbed by Albert Einstein as the eighth wonder of the world - it can theoretically result in exponential growth over time, and thus, an ever greater reinforcement of market leadership.

One of the most well-known examples of this is Coca-Cola. While alternative soft drinks manufacturers exist, Coca-Cola has been able to generate steady growth at good profit margins for well over a century. In Europe, a similar example would be Unilever, or Novozymes.

As European investors, we look for this kind of market leadership. Put differently, investors should theoretically like it when a company operates in a less competitive environment because it leads to more value creation and, therefore, higher returns to shareholders. And it is this value creation that can lead to outperformance in the stock market index. An active investor's job is to outperform the market and to deliver the best risk-adjusted returns for clients. Investing in companies that are continually fighting competition rather than creating value makes this difficult.

In itself, a market taking the form of a monopoly (or duopoly, or oligopoly) is not illegal or necessarily bad for consumers. There can be benefits associated with company size, such as economies of scale leading to cheaper goods for consumers. However, we advocate for regulation to address a lack of competition where a company engages in abusive behaviour, or attempts to gain market power through inorganic means. Indeed, this is where the law tends to focus. While our clients, as shareholders, benefit from a concentrated marketplace for our investments, we should always think about societal costs.

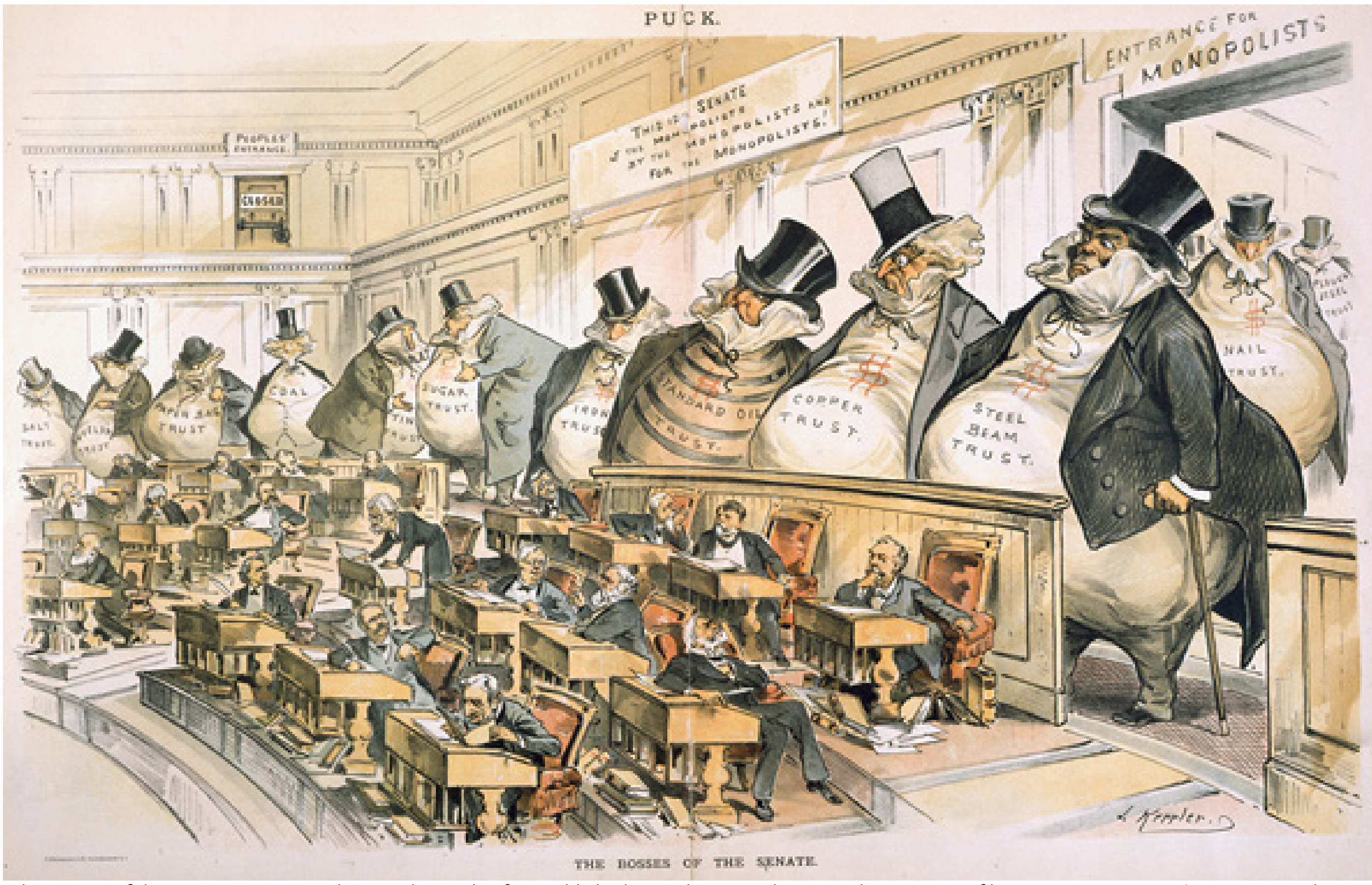
Economic theory suggests that there are real costs to consumers from a lack of competition and this is something that we will posit in this article. However, the way these costs manifest has evolved in the same manner that the nature of competition has evolved: technological advancements have led to a necessary change in the way that harm to consumers should be measured, and it has also led to competition on a global, not national scale. Current regulation is mostly focused on what we view as outdated measures of harm and is occurring only locally. Until multilateral competition commissions exist, which seems unlikely due to geopolitical reasons, there is a strong possibility that regulation could be causing consumers as much harm as it is providing protection.

Modern competition law and anti-trust

Europe has a long and colourful history concerning competition legislation. As early as 50 BC, Roman emperors came down very heavily on monopolistic and anti-competitive practices; under Diocletian in 301 AD, an edict imposed the death penalty for anyone found to be in violation of a tariff system, for instance by buying up, concealing, or contriving the scarcity of everyday goods. The origins of modern anti-trust law are in the U.S., a country that has a strong private sector tradition. While most might think of the U.S. as the pinnacle of a de-regulated, laissez-faire economy, anti-monopolist sentiment actually dates back to the foundation of the republic with the overthrowing of the British East India Company. It would seem an aversion to political monopoly extended to economic monopoly.[1]

The means of breaking up a company's market power through regulation or otherwise is known today as anti-

[1] We owe a debt of gratitude to the insights of historian Gary Gerstle on much of the history in this area.



"The Bosses of the Senate", a cartoon by Joseph Keppler, first published in Puck in 1889, depicting the interests of large American trusts (corporations dominant in steel, copper, oil and others) as giant money bags looming over the tiny senators.

trust. A 'trust' in the U.S. was the name given to a giant enterprise owned by wealthy magnates. These trusts amassed power through savvy business practices but it was a subsequent merger movement that allowed them to create single enterprises, be it horizontally (e.g. a steel company buys up other steel companies) or vertically (to seek to control every part of the production process, from raw material to finished product). With little opposition, these trusts started to appear in the oil, steel, beef and sugar industries, among others. Anything that could be produced at scale was susceptible to this kind of accumulation of power. This time in American history is often referred to as the Gilded Age. This term was used by Mark Twain and Charles Dudley Warner in a satirical novel about the era, to demonstrate that it was an era with serious social problems masked by a thin gilding, and therefore was by no means a 'Golden Age'. The trusts' anti-competitive practices were then exposed by the media, which had an explosive effect on American societies' views on monopolisation.

Public opinion had quickly flipped; people believed that this corporate power threatened the essence of the American republic that had been set up to protect the rights of ordinary people. The Sherman Antitrust Act of 1890 was the first measure passed by Congress to prohibit trusts. The Clayton Act of 1914 and the Federal Trade Commission Act of 1914 built upon the Sherman Act, and together these three pieces of legislation formed the basis for modern competition law in both the USA and Europe.

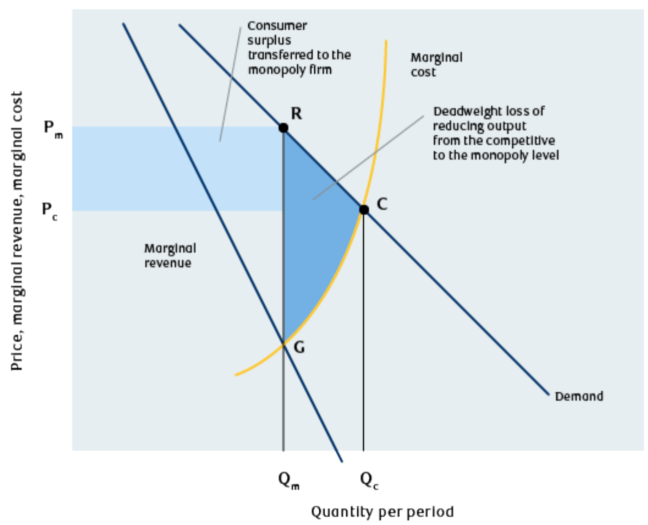
Anti-trust today: USA and Europe

Consistent across both American and European competition law is the principle that for the regulator to intervene in the private market, there has to be a case of abuse or harm to the consumer. It is not sufficient to break up a company simply because it is a monopoly.

In traditional industry, examining harm was relatively straightforward using pricing as the main parameter. A good example is Coca-Cola and Pepsi. A regulator would look at a scenario where Coca-Cola proposed to acquire Pepsi and examine the effect on the price of cola: an increase would be a negative for the consumer, and the regulator should oppose such a merger. This cost is known as consumer surplus, meaning the consumer would have to pay more for the same product and the difference would be transferred to the firm rather than retained by the consumer. Another potential cost is deadweight loss, or excess burden, which is the lost economic efficiency when the socially optimal quantity of a product or a service is not produced.

However, in today's world, there are many examples that not only indicate that we are in a new competitive paradigm, but also that the regulatory framework for assessing harm is not sufficient. These businesses benefit from network effects, where the utility for the user increases as other people use it. In other words, the larger and more dominant companies become, the more the consumer benefits. Therefore we have services that are either free or price leaders, that are also, at least superficially, very high quality (and increasingly so as the size of the platform grows). (Exhibit 1)

Exhibit 1: Consumer surplus and deadweight loss in a monopolistic market



Principles of Microeconomics, Professor Libby Rittenberg & Dr Timothy Tregarthen, 2009.

For example, when Facebook acquired WhatsApp, it actually made the service cheaper (free!), which benefited the consumer. Amazon, which is hugely dominant, has brought nearly free deliveries of a vast range of goods to millions, resulting in lower prices for consumers as well as more convenience. The platforms of Facebook and Instagram are also free to use. Google's algorithm is improved the more people utilise the (free) search engine.

The evidence is not just anecdotal: the OECD has found that markets – especially the U.S. - are becoming more concentrated.[2] This is not that surprising as the regulator in the U.S. has been far behind the European Commission in terms of prosecuting anti-competitive behaviour. Corporate break-ups are a rare thing for the U.S. government. The last major break-up of a monopoly was AT&T in 1982. Microsoft was ordered to split up by a federal judge in 2000, but this decision was reversed on appeal.

In the case of these newer industries, we can't necessarily rely on market forces to return the market to competitiveness. It might appear superficially that barriers to entry are low - it costs little money and time to develop a search engine - but these network effects lead to high switching costs, and the built-in lack of data portability and lack of privacy policy also mean that competition is hindered. (Exhibit 2)

Despite being free, high-quality services, there are several ways in which the dominance of technology platforms imposes harm on society at large, and this is something that is starting to be recognised by the regulator:

- **Lower quality products.** This is an evolution in thinking by the competition authorities. Competition can be on multiple parameters, price being one. Companies compete on other dimensions as well, however, such as quality. Competition officials now recognise that privacy protection is one such measure of quality that can be a metric on which to compete, thereby making personal data a currency. When Facebook first proposed merging with WhatsApp, the head of the European Commission stated that privacy did not play a role in anti-trust, but rather that it was a distinct goal. The thinking has since evolved. For instance, in the case of Microsoft and LinkedIn, the European Commission theorised that if Microsoft acquired LinkedIn it would give it an advantage over the German professional social networks it was competing against, and could hamper the competitiveness of these rival, smaller networks that offered consumers greater privacy protection.

- **Government lobbying.** To what extent can an online platform be co-opted to provide data to the government, for instance on surveillance? Even if the company is not co-opted, can the government tap into it indirectly without their knowledge?

- **Wealth transfer.** The traditional anti-trust concern is that the monopoly disadvantages consumers financially. This becomes problematic when the product is free. In a competitive marketplace, a company would pay for a consumer's data and/or content and the consumer would get something in exchange at a fair price, or get services valued at that price. With the current paradigm, consumers are effectively working for free and creating content without remuneration.

- **Suppliers.** These platforms can also affect suppliers upstream, extracting rents above market value. It also lends itself to behavioural discrimination as companies can use data to identify how much a

[2]Industry Concentration in Europe and North America, OECD Productivity Working Papers, No. 18, M. Bajger et al, 2019.

consumer is willing to pay for that product or service. No longer will there be one single price, but every person will get a different price.

- **Loss of trust.** Activity on a search engine would decline if consumers lost faith in the platform to keep data confidential (such as selling data on to insurance companies, thereby leading to higher premia.) The deadweight loss here is that the price a monopoly charges (lack of privacy) is above a competitive level (the level a consumer is comfortable with). As a result a platform will lose users had their 'price' been more competitive.

- **Harm to third parties.** These platforms have so much power that they can act unlawfully to kill competition. Venture capital funds often talk about 'kill zones' to mean business areas where one of these titans could kill a start-up's business model. Compared to the late twentieth century, access to data has accelerated the process of identifying nascent competitive threats which can stymie innovation.

- **Impact on individual autonomy.** Newspaper publishers are increasingly reliant on Facebook to reach readers, in the same way that merchants are on Amazon for their shoppers. These platforms have a massive influence on what individuals are able to see based on the design of their algorithms. For instance, the European Commission found in June 2017 that once Google vertically integrated and started competing in comparison shopping, the algorithm changed to favour its own service (case AT.39740). The European Competition Commission also ruled against Google in July 2018 for illegally using its Android network to restrict device manufacturers and other search networks to cement their own market position in these areas (case AT.40099).[4]

Exhibit 2: Market concentration and growth by industry, 1982-2012

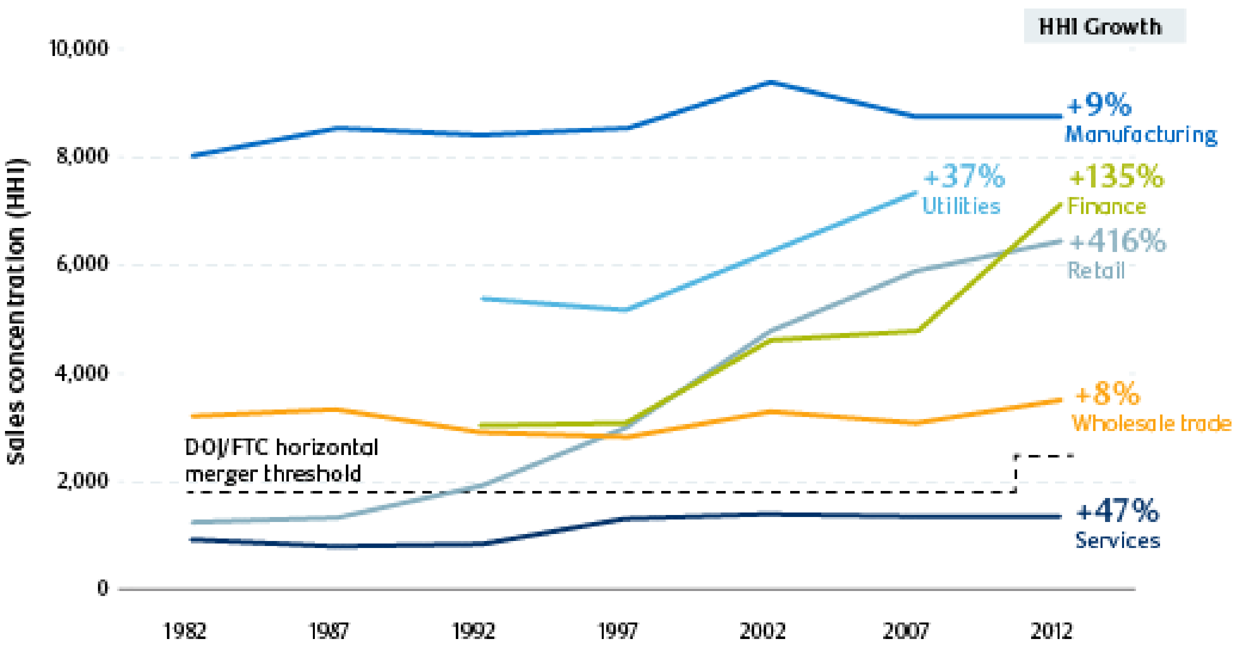


Chart showing that the Herschman-Herfindal Index, a measure of market concentration, has been increasing in most industries in the USA, in many cases far above the threshold required for the DOJ to oppose a horizontal merger. [3]

[3] The State of Competition and Dynamism: Facts about Concentration, Start-Ups, and Related Policies, J. Shambaugh, R. Nunn, A. Breitwieser, & P. Liu, The Hamilton Project, June 2018. [4] European Commission Antitrust website, https://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=1_40099, 2020.

The corporation as an extension of government: China (et al)

"Be in love with the government. But don't marry them" – Jack Ma, Alibaba, at the World Economic Forum in Davos in 2015.

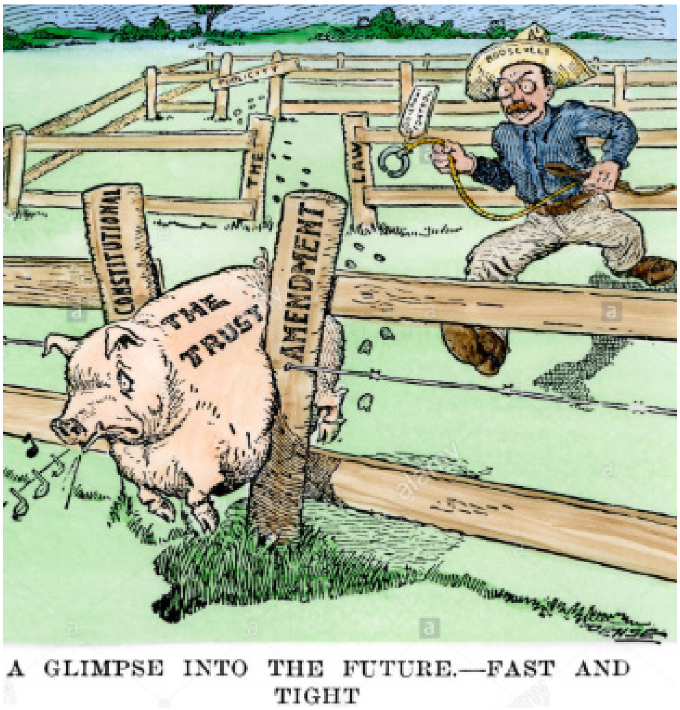
Governments apply anti-trust measures to concentrated industries principally to protect consumers at a micro-level, but also to inhibit companies becoming large enough to wield undue political influence at a macro level.

Surprisingly, however, we would also argue that there is a case for governments not to apply anti-trust measures. It is important to recognise that for centuries nation states have promoted the affairs of their companies abroad. Today, China is the best example of a nation where private and public sectors have been unmistakeably interlinked. Rather than companies being allowed to grow, unencumbered, to a size where they might exhibit political influence, the Chinese government can exercise influence in any way it chooses in these companies, and ultimately decide their fate. For example, the government is increasing its use of state-backed funds to invest in companies developing critical technologies, such as 5G and semiconductors; in 2018 the Cyberspace Administration of China and the China Securities Regulatory Commission released a plan to promote domestic Chinese markets to serve China's strategy to becoming a cyber-superpower, Huawei being the obvious example. The U.S. estimates that lost corporate earnings caused by alleged intellectual property (IP) theft or forced technology transfers in China is as high as $600 billion.[5]

This begs the question: if individual nation states are engaging in practices that result in unfair competition, whether outright theft or other means of government sponsorship, where does this leave anti-trust?

China is taking a much more global view of competition and sees private company dominance as an important, if not key, weapon in its foreign policy arsenal. China is not the only culprit. The U.S. has prosecuted far fewer anti-trust cases than Europe since the turn of the century. Moreover, the U.S. under the Trump presidency has become far more protectionist of American IP because of the fear of reliance on China for technology and the corresponding security and economic implications. This has resulted in the creation of national champions which benefit companies that, in a less globalised era, would arguably have been regulated much more heavily. Tencent, Alibaba, Huawei and Hikvision are examples of Chinese state-sponsored champions, and Facebook, Google, Amazon as American (indirectly) state-sponsored champions.

Yet encouragingly, there are early signs that bode well for increasing competition scrutiny in both the U.S. and even China, where anti-trust has historically played second fiddle to state sponsorship and an obsession with economic growth. On 10 November 2020, China's State Administration of Market Regulation (SAMR) issued draft anti-trust guidelines for the platform economy that we believe to be very forward-thinking. Their aim is to target orderly competition, reasonable pricing and - a significant development even in a global context - data protection. In the case of the U.S., in fiscal year 2019, the anti-trust division of the Department of Justice (DOJ) filed 20 briefs in district and appeals court cases in which it was not a party, outstripping any year since 1970, the earliest date for which the DOJ provides records.[6] In June 2019, the DOJ and Federal Trade Commission formalised anti-trust oversight for Apple, Amazon, Facebook and Google.[7]



Cartoon depicting Roosevelt using regulation to control trusts, c 1906, St. Paul 'Pioneer Press'.

[5] The Theft of American Intellectual Property: Reassessments of the Challenge and United States Policy, IP Commission Report, 2017. [6] The China SAMR anti-trust guidelines published on 10 November can be found on their website http://www.samr.gov.cn/hd/zjdc/202011/t20201109_323234.html. The name of the document, translated, is "Antitrust Guidelines on the Platform Economy Field (Draft for Solicitation of Comments). [7] Justice Department Reviewing the Practices of Market-Leading Online Platforms. https://www.justice.gov/opa/pr/justice-department-reviewing-practices-market-leading-online-platforms

Conclusion

The history of anti-trust behaviour and legislation is a complex one, and one that has ebbed and flowed over many decades. As we have demonstrated there is a fine balance to be struck between companies gaining market share and erecting barriers to entry in order to improve margins and lower prices to consumers, and monopolisation that may ultimately prove detrimental to consumers. What is proving more and more obvious however, is that legislation – and indeed action – have so far failed to keep up with the fast moving corporate landscape, often catalysed by technological disruption and advances.

In 2020 there was an almost unique harmony between consumers, policy-makers and regulators in the U.S. as they recognise the need to address the extraordinary scale, power and financial influence of monopolies that have sprouted in certain corners of U.S.-listed markets. This may be a direct response to the recognition that U.S. anti-trust enforcement over the last 20 or 30 years has been feeble. But it is this maturity of the U.S. technology sector that makes this kind of action appear necessary, and recent events concerning Facebook suggest that action may well be taken, rather than just strong words.

If action is taken in the U.S. or China, it would signal a distinct shift towards a European-style level of enforcement. But questions will be raised about how the world-leading EU legislation is enforced within Europe against its own technology sector. Europe, with its long history of large, global corporations, has represented the ‘old economy’ but there are signs that it is starting to foster an expanding technology sector of its own. If this begins to flourish, EU regulators and policy makers will need to think long and hard about how they can strike what appears to be a difficult balance. On the one hand they should allow large modern companies to establish themselves, thereby providing Europe with self-sufficiency and future growth, and investors with suitable returns. On the other they must ensure that growth and eventual size are managed in a way that guarantees that the detrimental economic and social costs that come with unconstrained scale and influence are prevented.

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Elma is a portfolio manager on the European Equity team at RBC GAM specialising in international funds. Elma returned to the UK in 2019 after two-and-a-half years in Sydney working for RBC GAM's Hong Kong-based Asian Equity Team. During that period, she worked on Asian and international funds, with a particular emphasis on the Australian and New Zealand markets. Elma initially joined the organisation in 2012 to form part of the European Equities team in London where she researched and invested in companies from all sectors across Europe.

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