RBC Global Asset Management

# Social media: Social licence to operate or time to licence social operators?

The RBC Global Equity team

Integrating ESG gives the investor a more complete and holistic understanding of the risks and opportunities facing a business. Where these are misunderstood by the market, they can contribute to market inefficiency which creates opportunity for outperformance by responsible stock-pickers. Our approach of focusing on the contingent assets that support healthy forms of extra-financial capital and avoiding contingent liabilities that arise from weak ESG practices is an example of how ESG may be used as a tool to add value to a portfolio.

However, one might argue that there is not much ‘contingent’ about ESG issues that are well understood; they are likely to be ‘in the price’ and thus less likely to contribute positively or negatively to share price performance and the stock-picker’s ability to add value. The tobacco industry is perhaps one such example: the harm caused from tobacco is well known, the industry is tightly regulated, taxed and, in some countries, tobacco firms have been forced to accept financial responsibility for the past harm their business models may have caused.

Even so, despite being ‘in the price’, it is debatable whether the industry truly adds value in a holistic sense. Arguably shareholder value is derived at the expense of other stakeholders, in particular users’ health. This raises questions about whether the business model has a net benefit for society as a whole or whether it is merely reallocating existing forms of capital - financial and non-financial - between different stakeholders.

This is why, before investing, we ask whether the business model has a net benefit. Wealth redistribution is not the same as wealth creation and ultimately is not sustainable as, in extremis, providers’ wealth is finite.

We prefer to judge business models on a case-by-case basis rather than taking an industry-wide view as we observe even bad things can happen in a ‘good’ industry.

In addition, when assessing a business we have yet to find one that doesn’t have any ESG risks at all. Just as there are no perfect people, there are no perfect companies. Our strong preference though is that company management teams acknowledge contingent liabilities where they exist and have strategies in place to manage and mitigate them.

Because industries change and new business models are being brought to market, this assessment has to be dynamic and apply industry context rather than relying upon ESG tick-boxing or dogma.

This approach has long made us wary of social media companies’ business models. These businesses generally rely upon advertising for their income which gives them an incentive to keep users on their platforms. Engagement is key; the greater the engagement, the more user impressions the business can sell to advertisers. This is not unique to social media companies, cable TV and newspapers have been doing the same thing for decades. However, what makes social media platforms different is their ability to obtain a very granular understanding of users’ likes and dislikes, enabling them to suggest posts and content that will increase engagement and time spent on their platforms. It is like being offered a personal TV schedule or news column tuned in to one’s preferences. But in the same way that newspapers have learnt that bad news sells, the algorithms that power the social media feeds have learnt that controversy creates engagement.

Our caution has been based on two principal areas of concern. First, that the algorithms make use of something B.F. Skinner called the ‘variable schedule of rewards’ to increase engagement. Instead of feeling sated, the sense of discovery and excitement from the next scroll creates desire and keeps us ‘hooked’. This dopamine-seeking behaviour is a normal physiological response and can be the source of addictive behaviour. It is alleged that the ‘gamification’ of social media platforms exploits this innate human response. It is a characteristic of society's response to addictive products and services that regulation is often introduced to protect individuals who are unable to protect themselves.

Second, that social media business models are failing in their stated purpose of bringing people together. We observe the reliance on likes and dislikes is creating tribes of like-minded users who end up having their biases reinforced and their outrage justified by the interaction they have with other users. Unfortunately, feeding users' dislikes also boosts user engagement, but with the unfortunate consequence of feeding unpleasantness and disharmony.

These concerns have kept us on the periphery, concerned observers but not investors. Very recently, however, these concerns have taken on a new dimension with principles of free speech and self-expression coming into conflict with society's sense of what is socially acceptable. Both free speech and social acceptance are important principles and any failure to observe either could jeopardise a business's social licence to operate. Yet amidst ongoing debate within society and the juxtapositioning of opposing views, the social media companies have found themselves uncomfortably positioned trying to tread a path between these two seemingly irreconcilable ideas.

Investors should acknowledge that it is the very success of the business models in question that has put them in this position. The positive network effects that give users the greatest utility from being part of the broadest platform have created de-facto monopolies for social platforms and messaging applications. This in turn has endowed the management teams running these businesses with great power and hence great responsibility.

The regulatory framework they operate under was perhaps sufficient when the business models were unproven in the early days of the internet. Rules such as the U.S.'s Section 230 meant that social networks could not be held liable for users' posts, creating regulatory space for innovation. This rule meant that social networks were not considered to be publishers, unlike the TV and newspapers of old. This appeared to tilt the business models towards free speech which was welcomed by many as a social positive contributing to the spread of progressive ideas and movements such as female emancipation or regime change, such as Eastern Europe's coloured revolutions or the Arab Spring.

But freedom of speech also confers freedom to disagree. Diversity of opinion is not inherently bad, but the manner in which disagreement is expressed has limits. In the physical world these boundaries are legislated for with laws against violence to individuals and property. But in the digital realm the boundaries of acceptable behaviour are undefined. It is said that offence is taken, not given, yet publishing slander and libel mean that within traditional media respect has to be given to the veracity of comments. No such presumption or oversight is mandated within the digital realm.

The recent denial of social media access to a number of high profile users has highlighted the absence of clear protocols and thrown the social media companies into the centre of this debate. One might agree or disagree with the decisions taken relating to particular users, but many will be justifiably concerned that small groups of unelected managers are being put in the position of having to make such important decisions at all.

A public conversation is now required to determine the boundaries of conversation in the digital realm. That conversation might very well extend to the adjudication of when those boundaries are exceeded and the governance surrounding the determination of appropriate consequences. A new regulatory settlement is required. Section 230 created space for innovation during the early days of social media, but as the platforms now mature the old regulatory settlement may no longer be sufficient due to its failure to address how dominant digital social networks have become and the increased influence and responsibility they now have.

We all have an interest in being part of this debate. Although many social media companies are listed in the U.S., their user bases are international which means the influence of U.S. legislation extends well beyond that one country's borders.

For investors in these business models there must be an acknowledgement that the eventual outcome is likely to impose changes upon aspects of these business models. Until now one could argue that the benefit of greater user engagement has been privatised in the form of shareholder profits but that the negative externalities have been avoided. Recent events have revealed worrying new externalities and the shortcomings of the current industry structure. Correcting the balance through public debate that leads to more balanced legislation is likely to impose change. This may involve greater cost should society determine that an enhanced level of oversight is required or oblige social media companies to accept legal liability for content.

This could alter the returns for shareholders, but shareholders would nevertheless be wise to accept rather than fight the changes. For without change there will remain the more profound question of whether social media business models have a 'net benefit' for society. Without that net benefit, the businesses will ultimately be unsustainable and will lose their licence to operate.

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Publication date: February, 2021. GUKM/21/025/MAR22/A

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