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SHOULD BIG TECH BE FEELING BLUE?

The blue shift in the White House may signal added trouble for companies such as Facebook, Apple and Alphabet.

By Max Gokhman, CFA, Assistant Vice President, Head of Asset Allocation, Pacific Life Fund Advisors

KEY TAKEAWAYS

While Big Tech was able to disrupt many staid industries over the last two decades, it may be unable to upend America's oldest institution—Washington.

- **With Joe Biden as the next president and a House of Representatives controlled by Democrats, we expect Big Tech to face major regulatory and antitrust headwinds that are likely to pressure share prices.**
- **At the same time, revenue for mega-cap tech companies may stagnate given the confluence of user saturation and a gradual return to a world away from screens, as the pandemic may recede next year amid emergence of a viable vaccine.**
- **Because of these significant headwinds, we are favoring smaller tech firms that are generally more focused on helping improve efficiency across enterprises than making a meme go viral.**

What is Section 230 of the 1996 Communication Decency Act?

This statute enables social media sites to let their users post content, even if it contains misinformation, and also moderate that content at their discretion without fear of civil litigation. This broad liability shield served as a potent accelerant for their growth (along with the viral misinformation and propaganda it empowered). The law, passed when Big Tech was tiny, allows these companies to act merely as platforms rather than publishers, meaning that, in most cases, they cannot be taken to court for user-generated content.

Any revisions to this rule would come with enormous enforcement costs for social media companies. Just in anticipation of potential reforms, or perhaps to appease legislators, Facebook has already spent $3 billion on content moderation or roughly 13% of its trailing profits.

As poet Percy Shelly pointed out in "Ozymandias," even the greatest kings eventually topple, and the "changing of the guard" generated by the 2020 elections may have sped up that fate for mega-cap tech companies in the U.S.

It's ironic that Big Tech has disrupted many staid industries over the last two decades, but FANMAG's (Facebook, Apple, Netflix, Microsoft, Amazon, and Alphabet, formerly known as Google) reign may be toppled by America's oldest institution—Washington.

Democrats will control the White House and the House of Representatives and may gain control of the Senate as well depending on the results of the two January run-off elections in Georgia. This means Big Tech will face stiff regulatory headwinds, which may blow even harder given the confluence of user saturation within consumer-focused tech and a gradual return to a world away from screens when the pandemic slowly recedes. We believe now is the time for investors in Big Tech to be cautious.

For much of 2020, mega-cap tech companies (those with market capitalizations of over $200 billion) appeared to be invincible monoliths. They didn't just survive the coronavirus-induced recession, they thrived, making them both a momentum and defensive play. For the first half of the year, FANMAG margins more than doubled that of the broader S&P 500® index with sales five times more than other firms in the index.

But Big Tech's sector and market dominance, consolidation and seeming inability to control misinformation put it in the crosshairs of both parties in Congress (for many Republicans, it was primarily an issue of perceived bias against conservative content with monopolistic concerns secondary). Before the presidential election, the Democrat-controlled House Judiciary Committee compared large-tech firms to "the kinds of monopolies we last saw in the era of oil barons and railroad tycoons."

Democrats in Congress felt uneasy that these new giants had grown, in large part, by acquiring competitors and consolidating market share. Some also were alarmed by the largely opaque relationship between some of the world's largest tech companies. These concerns were amplified in October when the Justice Department, ran by Attorney General William Barr—a staunch Republican and Trump loyalist—accused Google of using illegal measures to protect its monopoly and detailed exclusive agreements between Google and Apple (and others) to fend off competition.

"Two decades ago, Google became the darling of Silicon Valley as a scrappy start-up with an innovative way to search the emerging internet," the 57-page complaint said. "That Google is long gone. The Google of today is a monopoly gatekeeper for the internet, and one of the wealthiest companies on the planet."

The momentum of these antitrust proceedings is now poised to accelerate as the initiative may be one of the only pieces of legislation authored by Democrats that Senate Republicans can get behind. Bipartisan congressional support for tech regulation comes from the citizenry's growing concern that the benefits and convenience of technology often come with some dystopian strings attached. (Anyone who went into a shoe store with an iPhone in his or her pocket, only to find sneaker ads in his or her Facebook feed later in the day, can empathize with this uncomfortable feeling.)

Big Tech's tightening stranglehold on news and information has become another worry for lawmakers. Although Republicans have been more vociferous about bias in social media, Democrats also claim that the platforms represent a Wild West of unbridled information/propaganda and may target Section 230 of the Communications Decency Act that allowed Facebook and other social media companies to post third-party information on their sites without being responsible for the content. This issue is especially sensitive given the ongoing influence of foreign agents trying to sway U.S. elections by promoting disinformation, distrust and disunity.

Both antitrust and Section 230 legislative battles are likely to weigh heavily on large tech firms' profits, even if they don't immediately lead to enforcement actions. If this weren't enough, Big Tech will likely face more headwinds in 2021. With COVID-19 expected to increasingly come under control, especially as a viable vaccine looks increasingly likely to be rolled out next year, mighty tech tailwinds generated by the pandemic shutdown may dissipate as cabin-fevered consumers cut back on social media and streaming services and spend more money on dining out, entertainment and other pre-COVID activities.

Plus, during the pandemic, advertisers have piled their dollars into where the eyeballs moved to—streaming shows and social media—a migration clearly reflected in the latest crop of revenue beats from FANMAG. With the economy reopening, television production and college and professional sports have resumed, allowing advertisers to redirect some of their marketing spend to traditional media outlets.

Another possible wrench in Big Tech's growth is saturation. Is the rapid user growth on the wane? We saw that with Netflix and Twitter's third quarter 2020 reports:

- Netflix added just three million new users in the third quarter compared to 10 million new users in the second quarter.
- Twitter added just one million new users in the third quarter compared to a whopping 20 million in second quarter.

Meanwhile, Facebook saw its North American daily active users fall by two million in the third quarter and warned investors that it expects further declines in the fourth quarter.

Two other factors could challenge Big Tech: First, the absence of a polarizing, constantly tweeting president in the White House, which may serve to dampen social media engagement on both sides. Second, the shaky relationship between U.S. and China, a crucial market for global tech conglomerates. For instance, Apple recently jarred investors by reporting 29% lower year-over-year phone sales in China, leading to overall iPhone revenues falling by 21%. Although Biden may be less confrontational as president than his predecessor, he's nonetheless no China dove, which means the country's leadership may continue encouraging its citizens to buy local electronics (e.g., Huawei) over American ones.

Because of all these headwinds for the mega-caps, we are favoring smaller tech firms. These firms are generally less focused on spreading viral memes than on boosting business efficiencies through cloud infrastructure and data analytics. The B2B Software-as-a-Service (SaaS) should continue to gather momentum, even as we move past the pandemic. Moreover, earnings revisions for small caps are beginning to turn up while their valuations are far more palatable given that they did not partake in the meteoric rise of Big Tech. Just as Ozymandias' demise may have let new empires grow, regulations aimed at stifling monopolistic tendencies of the biggest tech firms should help smaller competitors gain market share.

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Mailing address:
P.O. Box 9768, Providence, RI 02940-9768
(800) 722-2333 • www.PacificFunds.com

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