FAANGS: Tech black swan in the wings?

BY **VANESSA DRUCKER** |

The US technology giants could be hit by extreme risks

Key points

- Data breaches, monopolies and taxation represent 'known' risks to large tech firms
- US regulation lags the EU's General Data Protection Regulation (GDPR) privacy rules
- Technology giants may be manipulating black box algorithms to support their business models

In recent years, American equity markets marched relentlessly higher, led by large high-technology stocks. Investors, however, have begun to question some factors underpinning their business models. During the Iraq war in 2002, US Secretary of Defense Donald Rumsfeld famously analysed threats as "known knowns", and "unknown unknowns". In today's competitive technology arena, dominated by Amazon, Facebook and Google, hazards can be divided into two camps – known and unknowable types of risks.

"You can plan around a risk if you know it. It's a 'black swan' that kills you," explains Mike Kosnitzky, partner at Pillsbury Winthrop Shaw Pittman, a New York-based law firm. He is using a term popularised by Nassim Taleb, a best-selling financial author, for unpredictable events. Challenges like data breaches, increased taxation, or anti-monopoly regulation can be assessed and addressed to some degree in advance. Boards of directors can foresee the likelihood of data breaches, for instance, even if they do not know exactly how they will come about.

Or they can analyse the risks of competition and take actions to limit them.

But the most insidious black swan for technology and social media may be arising from manipulation. The public is aware, and growing uncomfortable, that social media platforms utilise unrevealed algorithms to gauge users' commercial and political preferences. The latitude to exploit these advantages might not last indefinitely. Stricter oversight, coupled with public disenchantment, could directly hit the firms' bottom lines.

Clear and present dangers

Data breaches represent a known and foreseeable struggle, destined to dog the industry. They present a perennial cat and mouse game, as the companies strive to keep up with the hackers. In October it was revealed that Google (a unit of Alphabet), exposed data of hundreds of thousands of users of Google+, including full names, email addresses, birth dates, gender, photos, occupations, and relationship status.

Even more disturbing, Google hid the incident for six months, to protect its reputation. Meanwhile, the US Federal Trade Commission has been investigating how the data of up to 50m Facebook users was provided over many years to the political consulting firm Cambridge Analytica.

Monopoly status is likewise a clearly known risk, and one likely to provoke regulation. Europeans are already more determined than US regulators on "ensuring a level playing field for any company at any size to compete," says Ali Mohgharabi, senior equity analyst at Morningstar. American counterparts, at this point, are most interested in who is providing the best service for consumers.

Democratic Senator Elizabeth Warren criticised Amazon in September for its "special information advantage" in promoting its own products against competitors in the very marketplace it is providing.

Amazon's position at the hub of e-commerce forces other third-party vendors to depend on it, allowing it to parlay information on companies using its services to undermine that competition. The company's information on what is 'hot' gives it an unfair advantage, so it can jump in and take market share, says Brian Milligan, portfolio manager at the Ave Maria Growth fund, part of the Ave Maria Mutual Funds, a US faith-based retail fund manager.

Milligan, having examined the past 10 years of Amazon's annual letters and transcripts of shareholder meetings, reports how owner Jeff Bezos has avoided those calls in recent years.

Milligan asks: "Should a company of that size only meet investors one day a year?"

Andrew Acheson, managing director in Amundi Pioneer's Boston-based US growth team, considers the futility of splitting the social media pie into multiple companies, since the exponential value lies in the network itself. If each were identical in size and revenues, the separate values would still be less than one integrated whole.

Firms are well aware that politicians are scouring the new economy for fresh sources of revenue, particularly taxation. Higher taxes may be irksome but at least they can be factored into companies' planning. Until now, companies have arbitraged tax rules around the world, playing off jurisdictions and shifting income into lower tax rate locations. "Taxing authorities have become wise to that," Kosnitzky warns. "Business presence, whether by media or sales, is being scrutinised and inter-company pricing is under a microscope. Companies will need real substance in jurisdictions to deflect income there."

Manipulation – the big unknown

A looming threat to the tech giants is a growing sense that they are manipulating us, or intending to do so. As private companies, can they overreach where government cannot?

Search engines appear to provide useful information but are tucked inside black boxes. In theory, rankings depend on how often they are read by others. "We need to see the algorithms to know whether they are playing fair," says Acheson, adding, "we can see it in a newspaper, but not in a black box fed by a machine, even if it's innocent." Users of these services are themselves the product, rather than merely customers. Their data is being monetised through advertising. Next, the question arises, are the search engines prioritising products based on advertising revenues? At the same time, "creepier aspects of location, search history, and habits online are concerning some people", Acheson notes.

Others may not care how their data is used, or might even enjoy receiving more targeted advertising. "Kids still like it because it is free," says Neil Dwane, portfolio manager and global strategist at Allianz Global Investors. Yet even Facebook is losing some cool in middle age. A May 2018 Pew Research Center Survey showed that one third of teens use Snapchat or YouTube most; 15% visit Instagram most, and only 10% use Facebook.

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As long as most advertisers regard online channels as cost-effective, demand to buy advertisements from both Facebook and Google will remain strong. The trade-off is working, with users willing to accept the ads. If it turns out that the companies eventually have to charge, users' attitudes may change. "We've seen Google trying that out, with YouTube Premium, for which users pay $10 (€9) a month not to see advertising," says Mohgharabi.

It is an irony that the stigma of data privacy works to the advantage of existing larger companies and creates barriers to entry. A large firm generating cash flow can more easily afford lawyers and lobbyists and communications writers to produce guidelines, and so on. Newer entrants will find it harder to follow.

So far, Google and Facebook have also been able to sidestep onerous media regulation, "by masquerading as technology companies", Dwane says. "While media would have a higher duty of care to be transparent, Facebook claims just to be multiplying what your friends are already saying, as an echo chamber." That posture frustrates competitors who must fight with traditional standards that govern news providers.

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In Europe, regulators have taken a key step by issuing the General Data Protection Regulation (GDRP) to reshape how data is handled in every sector. Nevertheless, Google and Facebook are finessing the new rules by nudging users toward accepting privacy options with misleading or obscured default settings, or by requiring extra efforts.

The US lags in regulation, in part "because there isn't a body to perform that role. The Republicans are generally against more regulation – even if they don't like being manipulated either," Kosnitzky says. Regulation is a slow process but the technology powerhouses may eventually pay a steep penalty for their manipulation of consumers' data. That techlash price may turn out to be the real game changer.