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INSIGHT

VIEWPOINT

The Price of Privacy

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As of June 30, 2019, IT represented 21.5% of the S&P 500 and 33.6% and 9.7% of the Russell 1000 Growth and Value Indices, respectively. Post the Russell's annual rebalancing, effective July 1, IT represents 37.6% and 6.0% of the Russell 1000 Growth and Value Indices, respectively.

Many "big tech" companies face regulatory or legislative action on multiple fronts, but the issues generally can be broken down into two buckets: privacy and antitrust. Privacy seems to be a more widespread concern, while companies face antitrust issues to varying degrees.

Facebook and Google in particular have come under fire for improperly monetizing their users' data, potentially including browsing history, transactional data, location information, and other proprietary feeds. There have also been well-publicized incidents of Smart Watches from Apple and Smart Speakers from Amazon and Google listening to, responding to, and acting on private conversations that were never intended to be heard by the devices. Many countries now require data on local customers to remain in-country, requiring build out of local storage capability as needed, which is not particularly expensive or difficult. For companies that generate revenue through advertising, accumulating customer specific data is a competitive advantage and more likely to generate click-throughs and revenue. Notably, Apple has built its reputation around privacy and thus far there is little or no evidence that Apple misuses customer data. Others will have to defend their current and past practices. One justification we would expect to be touted is that advertising-based business models keep the web (or social media or internet platforms) free for users. It is not clear how much consumers are willing to pay to keep their data secured for access to Facebook or Instagram, for example. We expect privacy issues to remain in the spotlight for the foreseeable future. Notably, post the close of Friday, July 12 the WSJ reported that the U.S. Federal Trade Commission approved a ~$5 billion fine levied against Facebook for violating their consent decree for earlier policy violations; representing 9% of their last 12 months (LTM) revenue and 22% of their LTM adjusted net income. However, the $5 billion was within company expectations and unlikely to be market moving. Data breaches and reparations are likely to be highlighted throughout the 2020 U.S. election cycle and elsewhere. In the future, users may be given the choice of opting out of data collection/ retention policies. In some countries, opting out may become the default position, with users having to opt in to a data collection policy. The implication for the technology providers has less to do with cost (these are relatively "easy" protection/security fixes) and more to do with fines and potential revenue impact. If companies are less able to serve highly targeted ads that generate significant traffic, advertising revenue could drop considerably damaging positive market sentiment for these names.

Antitrust issues may be the bigger risk, but also more difficult to address. Regulators are looking closely at Apple for antitrust reasons related to their app and music stores. Because Apple has complete control over who can publish apps – and therefore access users – it could be determined that this gives them an effective monopoly over iPhone apps and that the 20-30% fees they charge developers for access to this platform constitute an abuse of that position. Apple has always maintained that keeping strict control over the app store safeguards users from malicious code and inappropriate content while enhancing security and privacy. However, the downside scenario for the company includes lowered or eliminated developer fees which would reduce the growth rate of Apple's services business and delay the shift from their hardware-centric model to the recurring revenue of subscription services like apps, music, and entertainment.

A significant hurdle for any government regulator will be first to establish that a monopoly exists and second to demonstrate the consumer was harmed by its existence. Apple will likely argue that they are a distant #2 in smart phone market share. Amazon will likely argue that, while its revenue is large in absolute terms, it still represents perhaps 3% or less of all U.S. retail sales. Both Amazon and Google/Alphabet are known to drive prices down materially in all areas they invest in, which makes proving consumer harm very difficult. One of our analysts calculated there are as many as *2 trillion* worldwide free Google searches every year. Facebook will likely argue that their business competes with email, video chat, phone calls, and myriad other communications platforms available online and, since it is free, there is no harm to the consumer anyway (unless private information is violated). Google, however, does have dominant positions in digital advertising (along with Facebook, to a slightly lesser extent) and internet search. Google's Android operating system also powers around 85% of all smartphones which gives them access to user data that other companies do not have and therefore, in addition to the privacy issues, could be the most liable to raise antitrust concerns. Recently, both Facebook and Google were warned by Australia's Treasurer "to expect strict restrictions on their market power," so more fines and/or restrictions are likely.

Based on what we know so far, fines and headline risk from various investigations and hearings pose manageable risk. If investigations and fines morph into antitrust cases which result in permanent changes to business models, then future growth and above market valuations could be significantly impacted. Facebook and Google appear to have the highest risk, while Amazon is deemed to have lower risk in light of the prima facie savings they provide consumers. Apple appears to carry less risk on the privacy front but could face pressure to disaggregate its hardware and services businesses, perhaps bearing the lowest risk of the four in aggregate and combined with the lowest of the four's overall valuations with the exception of price-to-book. Microsoft, Amazon, Apple, Google, and Facebook (in that order) are the five biggest companies in the S&P 500 by market cap although only Microsoft and Apple are classified as IT companies. Increased scrutiny concurrent with fines are considered "the cost of doing business" for most technology investors today. Antitrust legislation in major world markets would impact the equity performance of these companies and general U.S. equity market sentiment for a quarter or two until other market cap stocks and sectors attracted investors for their relatively attractive growth rates.

5-Metric Screen

S&P 500			**2.4**	**13.0**	**17.2**	**3.5**	**1.9**		
Ticker	**Cap**	**Price**	**P/S**	**P/CF**	**P/E**	**P/B**	**Yld**	**S&P 500 X / 5**	**Max Upside to S&P 500**
MSFT	$1,075,523	$140.72	8.6	20.7	27.0	10.5	1.3	0 / 5	-32%
AMZN	$984,399	$2,000.81	4.2	31.7	70.7	20.3	0.0	0 / 5	-42%
AAPL	$961,402	$208.67	3.9	13.4	17.4	9.1	1.5	0 / 5	-1%
GOOGL	$791,864	$1,139.73	5.8	16.5	23.6	4.3	0.0	0 / 5	-18%
FB	$584,509	$204.66	9.4	17.8	23.5	6.6	0.0	0 / 5	-27%
V	$400,943	$183.33	18.1	33.0	30.6	13.6	0.5	0 / 5	-44%
MA	$286,808	$280.25	19.5	46.9	35.6	55.5	0.5	0 / 5	-52%

Source: TCW, FactSet; As of July 24, 2019.

Second Quarter Earnings Expectations and the Impact to the Overall U.S. Equity Market Performance

Despite initial estimates which forecasted negative results, 1Q19 S&P 500 earnings were up 1-2% with revenues expanding at a 3% pace. Knowing what we know today, earnings are estimated to be flat in the second quarter but should reaccelerate into the second half of the year to a 5-8% growth rate in the fourth quarter with revenues to continue to expand at a 3%+ pace throughout 2019.

2019 S&P 500 Earnings and Revenue Estimates by Sector

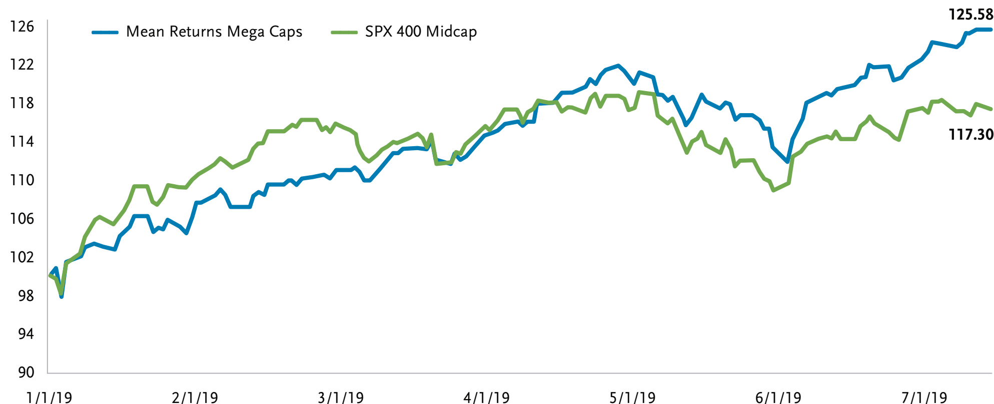
	2019 Earnings				2019 Revenues			
	1Q	2Q est.	3Q est.	4Q est.	1Q	2Q est.	3Q est.	4Q est.
Communication Services	-9.9%	16.4%	1.0%	3.6%	14.3%	14.3%	10.7%	8.4%
Consumer Discretionary	7.9%	0.2%	7.7%	10.1%	3.8%	3.7%	5.6%	4.9%
Consumer Staples	0.9%	-1.3%	1.8%	3.3%	2.5%	2.5%	3.7%	3.9%
Energy	-26.1%	-0.5%	-9.3%	-4.6%	2.0%	2.0%	-0.2%	-7.8%
Financials	8.0%	6.1%	7.0%	18.9%	0.6%	0.6%	-0.1%	13.5%
Health Care	10.3%	2.8%	3.2%	8.8%	12.3%	12.3%	12.6%	10.5%
Industrials	6.9%	-0.1%	6.6%	10.0%	1.3%	1.3%	3.2%	4.6%
Materials	-13.3%	-27.4%	-11.1%	-7.6%	-14.8%	-14.8%	-9.3%	-11.4%
Real Estate	6.3%	1.2%	3.5%	6.2%	3.8%	3.8%	4.2%	3.6%
Information Technology	-1.1%	-8.2%	-5.0%	5.0%	-1.1%	-1.1%	0.2%	4.0%
Utilities	-0.5%	2.4%	4.3%	16.5%	3.9%	3.9%	7.4%	3.0%
S&P 500	**1.6%**	**0.4%**	**1.5%**	**7.8%**	**3.8%**	**3.8%**	**4.3%**	**5.0%**

Source: Strategas/First Call

While S&P 500 valuations are at or slightly above long term averages, there is a big discrepancy between the valuations and performance of the mega caps and the mid-caps as represented by the S&P 400. With valuations in many mid-size companies and value sectors close to historically low levels, it is not surprising companies flush with cash and available low interest rates have begun to step up strategic acquisitions such as Fiserv's offer for First Data, Infineon's bid for Cypress Semiconductor, and Abbvie targeting Allergan. Therefore, we expect the almost two standard deviation valuation lows for value versus growth and nearly one standard deviation valuation lows for mid-cap versus large caps to be either reassessed by investors or have forced increases in valuation due to strategic purchases and thus will have a positive impact to the overall U.S. equity market performance.

The chart below depicts the S&P 500 mega cap ($250 billion and greater market cap) year-to-date returns relative to the S&P 400 Mid-Cap ($700 million to $21 billion) returns.

S&P 500 Mega Caps vs. SPX 400 Midcap (Capital Appreciation)



Sources: TCW, Bloomberg; As of July 11, 2019.

The second positive phase of the U.S. equity cycle commenced when top line growth accelerated in early 2017. There was nothing wrong with portfolio earnings and revenue in late 2018. Rather, it was recessionary fears from tariffs, the government shutdown, and the Fed's wildly unpopular December hike that overshadowed fundamentals and precipitated the decline in the fourth quarter. Once 4Q18 earnings season commenced, company reports came in as expected or better. The Fed's more dovish turn (i.e., increased likelihood for future rate cuts) and growing hopes for a trade deal between the U.S. and China provided an additional boost to equity markets. As recently as February, the consensus was for a decline in 1Q19 year-over-year earnings. ■

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Ms. Jaffee is the Senior Portfolio Manager for the TCW Relative Value Large Cap, TCW Relative Value Dividend Appreciation, and TCW Relative Value Mid Cap strategies and funds. She joined TCW through the acquisition of SG Cowen Asset Management in 2001. She had been a Senior Portfolio Manager at Cowen Asset Management since 1995 and continues in that role at TCW. She has more than 30 years of investment experience. Before joining Cowen, she was Vice President and Portfolio Manager at Kidder, Peabody & Co from 1986 to 1995. Prior to that, she was Vice President at Lehman Management Company from 1985 to 1986 and an Equity Analyst with Prudential Insurance from 1982 to 1985. In 2007, Ms. Jaffee was named the Separately Managed Accounts Award winner in the Large Cap Equity category by Standard & Poor's and its award partners Prima Capital and Investment Advisor magazine. The TCW Relative Value Large Cap, Dividend Appreciation, and Mid Cap mutual funds have been each awarded Wall Street Journal's "Category Kings" in their respective categories, multiple times in 2012, and the TCW Dividend Appreciation Fund was ranked the #1, top performing fund among Lipper Equity Income Funds for 2012. In 2013, the TCW Relative Value Large Cap mutual fund was ranked #1 fund for the first quarter and the #6 fund for the one-year period ending March 31, 2013 among Large Cap Value peers, while the Dividend Appreciation Fund ranked #2 for the quarter and #3 for the one-year period ending March 31, 2013 among Equity Income peers. Ms. Jaffee holds a BA in Economics from Wellesley College (1982). She has completed post-graduate work in Finance and Accounting at Rutgers University Graduate School of Management and is a CFA charterholder. Ms. Jaffee is also a member of the New York Society of Security Analysts, the Economic Club of New York, and the CFA Society.

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Mr. Fifer, Senior Analyst, is responsible for the technology sector and the drug and device side of the health care sector. He joined TCW in 2002. In 2005, 2009, 2010, 2011 and 2017 (tied with Sung Chung), Mr. Fifer earned the group's highest merit bonus based on stock selection. He has more than 20 years of investment experience having previously spent seven years as a sell-side Equity Research Analyst covering telecommunications services, equipment and software industries, and received recognition in the Institutional Investor survey for his work on wireless carriers. Mr. Fifer holds a BS in Civil Engineering from Bucknell University. He is a CFA charterholder.

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