

## **Ad Hoc Memorandum: Amazon Minority Report**

Few opinions are as tightly held on Wall Street as the view that Amazon is irrevocably dominant. The mix of a visionary CEO and superior industry positioning has created a company that has remade the retail industry and potentially threatens others. In my view, Amazon is a terrific company, but the rise and continued evolution of the digital assistant may result in a worse Amazon economic model going forward. While the Echo, Amazon's smart speaker, is perhaps the most successful implementation of a smart assistant ("Alexa") in the home, it may prove to have been a defensive necessity whose fundamental flaws point to larger challenges the company will face in its base business.

As a speaker-only intelligent digital assistant, the Amazon Echo has a learning disability – it cannot distinguish between correct answers and incorrect answers. The key to gaining intelligence and becoming contextually aware is creating a feedback loop. With the Echo, when the device presents an answer to a user's query, whether it provides a useful answer or not, the user responds similarly. He stops interacting. Without confirmation, there's no feedback loop that confirms the appropriateness of an answer that can be used, right or wrong, to become more intelligent.

Given the limitation, the Echo and Echo Dot are better seen as "doing" devices. When ordering products from Amazon's marketplace, Alexa presents users of the Echo and Echo Dot with clean action trees. Without the need to react to variation in feedback, it's an excellent experience. Similarly, the Echo, through the extensibility provided by the "Skills" functionality, works well as a smart home appliance, providing central voice control of a variety of smart devices that are enabled and connected to the device. It's great at doing things. That openness, the hallmark of creating a larger ecosystem that perpetuates a platform, however, is also a vector to lessen Amazon's influence.

Amazon at its most basic level can be understood as a tax on the goods and services it sells. For the most part, it does not manufacture or create goods, but brings buyers and sellers together for which it receives a healthy retailer margin. Profits therefore are most levered to selling as many items as possible. Their implementation of a personal assistant can be understood as a way of decreasing the friction of ordering from Amazon.

Other personal assistants don't share the same guiding light. Without the marketplace business to protect, other assistants can more directly customize the experience for the client. The reason that many people order from Amazon is their combination of generally low prices, fast shipping, and broad assortment. In a computer and mobile centric world, without personal digital assistants, it's one place to order and track shipments. However, as fast shipping has become a requirement to compete in retail and lower prices can be found elsewhere for many of Amazon's goods, the glue that has held the audience together will become its assortment. Already Microsoft's Cortana and the Google Assistant track packages skimmed from Microsoft and Google email accounts, even if their implementation of that functionality to the user is poor. As that implementation is improved and consumers can order with their voice the necessity of ordering from Amazon decreases.

And Amazon's competitors have willing partners. Amazon has used its market power to squeeze consumer packaged goods manufacturers ("CPGs") margins using their data to identify the most valuable and highest velocity items to introduce their own competitive product. CPGs have suffered. A delicate move towards self-fulfillment of online retail orders has been explored by the most forward thinking of those companies. They understand the strategic need to directly fulfill and are coming to terms with the upfront costs of developing the capability. With Google, Facebook, Microsoft, and Apple in the US, and



other large companies abroad making online payments easier, Amazon faces stiff competition in the business of matching buyers and sellers by companies who have their own relationship with the consumer and the ability to develop relationships with companies who want that connection.

Strategically, the quick win that Amazon had with the Amazon Echo may become a longer-term loss. Personal digital assistants are in their infancy despite their ubiquity and it's unclear how widespread user acceptance will be. Time will tell whether Amazon educated the consumer on a new form of input only to have it be taken over by another player, or whether they'll be able to extend their business into the home and prove the Amazon believers right.

I think it's less than a foregone conclusion, but I've never been one for consensus thought.

Sincerely,

A handwritten signature in cursive script that reads "Basil J. Alsikafi".

Basil Alsikafi  
Portfolio Manager  
White Brook Capital LLC

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