

Why Nasdaq Loses When the Government Wins

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Judge Thomas Penfield Jackson Monday affirmed the Justice Department's allegation that "Microsoft's conduct adversely affects innovation . . . impairing the ability of Microsoft's competitors and potential competitors to obtain financing for research and development."

But Microsoft's actions may be less harmful to its competitors than the Justice Department's actions are. Monday, on news that the antitrust settlement talks had collapsed and in anticipation of Judge Jackson's anti-Microsoft ruling, the tech-heavy Nasdaq Stock Market plummeted 349 points, or 7.64%, its worst one-day performance ever. On a day the Standard & Poor's 500 and Dow Jones Industrial Average both rose, the loss of Nasdaq value was about \$450 billion. Some \$80 billion of that was accounted for directly by Microsoft, whose shares lost 14.5% of their value.

So where are the winners? The antitrust policy payoff is supposed to be in rewarding victims of high prices and anticompetitive practices. Yet, the high-tech Nasdaq firms allegedly hurt by Microsoft's practices see their stock prices reeling in the wake of the Justice Department's victory in court. The hundreds of billions of dollars in losses wiped out capital that entrepreneurs were eager to use to research markets, develop innovative technologies, launch new products. Microsoft may try to suppress high-tech innovation, but the Justice Department is succeeding.

The stock-market reactions to the Microsoft case are illuminating. In computer markets, hundreds of companies (and their customers) stand to benefit from a case against Microsoft if it really expands customer choice in operating system software, improves functionality and slashes prices. But on key dates in the years-long investigation and litigation against Microsoft, investors typically sell computer-industry stocks when the Justice Department wins. Note two important dates from either side of the coin.

Monday, Microsoft was hammered by expectations that it would lose in a harsh verdict. This crushed Microsoft shares, but also wiped out a wide array of computer and computer-related stocks, using the Nasdaq index as a proxy for these issues. Conversely, the last time Microsoft won a major antitrust ruling -- on June 24, 1998, when a federal appeals court overturned a lower-court verdict that Microsoft had violated a 1995 consent decree reached with the Justice Department -- Microsoft shares soared 4.2%, and the overall Nasdaq was up 1.8%.

These results are part of a pattern we have discovered in examining stock-price reactions to numerous antitrust enforcement actions against Microsoft going back to 1991. In a study published in last month's issue of the *Journal of Financial Economics*, we show that

when antitrust actions against Microsoft move forward, Microsoft shares and a computer industry index (excluding Microsoft) both tend to drop by statistically significant margins. When antitrust actions against Microsoft are set back, both Microsoft and other computer stocks go up. In short, the computer sector generally -- and substantially -- moves with Microsoft, not against it.

Not that some individual stocks don't benefit from the Justice Department's attack. Monday VA-Linux shares rose, presumably on expectations that Microsoft will be a less formidable competitor if it is constrained by a damaging verdict and strict remedy. But an occasional uptick among ardent Microsoft foes is hardly evidence in favor of the antitrust case as a boon to consumers or computer companies in general.

More interesting is that when antitrust regulation adds uncertainty to an already volatile sector, even supposed beneficiaries of the Justice Department's attack on Microsoft can be swept to sea in the resulting tsunami. Monday, shares of Apple, Red Hat, Sun, Oracle and Novell all declined. Companies in the computer sector are highly complementary. Networks, applications and systems must fit together in subtle and sophisticated ways. It is difficult to substantially reconfigure one major player without doing damage all around.

Hence, the general devastation wreaked on the tech sector. This is destructive on its own terms -- denying needed capital to competitors and complements of Microsoft alike -- and indicative of the fundamental economic reality underlying the case. Those investing their own resources are betting that software markets will not be made more efficient, nor will consumers be made better off, by a government success in U.S. v. Microsoft.