EQUITIES » The world of e-tail – buying and selling online – is growing, and could present excellent investing opportunities

Survival of the fittest in a virtual world

Online shopping: the old ways of shopping are becoming almost obsolete

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The term 'survival of the fittest' has come to be widely misused. It has nothing to do with whether an individual organism is physically strong enough to prevail in the competition for food and mates.

Charles Darwin – and before him Herbert Spencer – intended it as a synonym for natural selection, a metaphor for adaptability to a species' immediate environment.

In this original and correct sense, the phrase is still one of the most apt descriptions of what happens in the economy. It seems especially applicable to the retail arena and, by extension, the investment world.

In fact, Darwin's theory of evolution owes much to his reading of Adam Smith, the first modern economist, and his ideas regarding competition between firms based on innovation. Smith presaged that reacting to ever-changing economic conditions is essential for business success and that brands that fail to employ innovative strategies would likely go the way of the dinosaurs.

At present we may well be witnessing perhaps the most fundamental chapter in the evolution of the private business – the internet revolution. In 1776 Adam Smith wrote that "the division of labour is limited by the extent of the market". Today the internet has essentially created a global market made up of those of us who are computer-literate and networked.

One result of this is that there are almost no boundaries to the specialisation of trade. Another is that many products are now produced and distributed at near-zero 'marginal' cost (the additional cost for each extra unit produced), which means unprecedented numbers of people can enjoy the fruits of human endeavour – music, literature, movies and scientific innovations.

In fact, many economists believe zero marginal costs will mean prices will also tend towards zero in the long run.

Bearing all of this in mind, how and why would one nowadays invest in the average brick-and-mortar UK high street? To answer that question we need to examine our changing concept of shopping and the remarkable and relentless demands it is making of companies around the globe.

We all appreciate, of course, that digital commerce and 'e-tailing' are rapidly catching up with the more conventional shopping experience. Research commissioned by price-comparison website Kelkoo suggests online sales accounted for 12 per cent of all UK retail trade in 2011.

Question of trusts

Naturally, though, there is a hitch. Although they are cheap, electronic trade transactions on the internet lack an important lubricant of face-to-face trade: trust. Economists have known for a long time that we make transactions in markets at a significant cost that comes partly from the need to be circumspect when our trading partners have incentives to exploit us. This is why we monitor whether others have stuck to their part of the bargain or go through the courts to seek compensation.

In a better world we could dispense with these checks and the time and money they entail. Investing and repaying trust is partly in our instincts, especially when we can gauge trustworthiness based on gut feeling or past experiences.

Obviously, our instincts have nothing to work on when physical cues are missing – so is this an obstacle to the rise of internet shopping and online retail? It would seem not. According to a study by Nottingham University Business School, this hurdle has now been cleared.

The School's International Centre for Behavioural Business Research (ICBBR) recruited more than 100 volunteers to take part in a series of experiments that saw them placed in pairs and asked to play the trust game, which is widely used in the field of experimental economics to examine strategic behaviour in real-life situations.

In the game a 'sender' is given a sum of money and invited to send any part of it to a 'receiver'. The amount sent is tripled before the receiver decides how much to return. The sender keeps whatever he chose not to send plus what he gets back, while the receiver keeps whatever he decides not to return.

In theory, a rational receiver would return nothing – and a rational sender would anticipate as much by sending nothing in the first place. As the world of finance has come to know only too well, however, human beings frequently find rationality an elusive quality. In practice, the average amount sent in the trust game is half the original stake, while the average amount returned is what was received – that is, the amount before tripling.

The experiment was carried out via a website and in the 3D virtual world *Second Life* before the results were compared to those of similar studies in a lab setting. Researchers measured 'trustingness' by using the percentage of the original stake sent and 'trustworthiness' by using the amount returned.

Trustingness stood at 38 per cent among website users and 61 per cent in the *Second Life* setting, compared with up to 60 per cent in a series of lab tests. Trustworthiness reached 24 per cent in the website scenario and 38 per cent for *Second Life*, compared with up to as little as 28 per cent in the lab.

What do these results show? Most importantly, they provide no evidence of reduced trust in electronic environments compared to a real-world setting. We are just as happy doing business in cyberspace as we are doing business face-to-face, and many of us are more prepared to trust an avatar than we are to trust someone in an old-fashioned, eye-to-eye deal.

In addition, the findings suggest that if trust enhances retail then e-tailers might successfully exploit virtual-world technology for this very purpose. One option is to establish a presence within virtual worlds such as *Second Life*, which has roughly 1m users. Another is the inclusion in online interfaces of a virtual-world element that allows visitors to encounter other customers' and employees' avatars.

Such strategies might seem bizarre and even frightening to many, but studies have already shown how virtual residents tend to identify with all community members in their chosen world and so consider them part of the 'in' group. Virtual personal relationships among avatars are often highly significant and help counteract the inherent scope for anonymity.

Moreover, avatars are capable of recreating many of the elements of a real-world encounter, including eye contact and body language. The most likely source of virtual trust might therefore lie in the way an artificial 'social presence' is designed to simulate aspects of the physical world.

It hardly need be said that the findings of the ICBBR's study will do little to quell increasing fears that the time-honoured idea of shopping is being eroded by the quickness and convenience of online alternatives. The inescapable truth is that the implications for e-tailers are extraordinarily positive and easy to exploit, whereas the implications for the high street, by comparison, are overwhelmingly negative and difficult to address.

Already the onus is on the latter to revamp and redefine its offering, most commonly through augmented reality (AR) and other mobile phone services that are directly tied to the physical act of shopping. In-store wi-fi is all but imperative. The list of relevant apps grows. 'AR shopping windows' are appearing in major cities across the world. Apple stores in the US allow customers to scan products using their iPhone cameras and pay through their iTunes accounts. No wonder we are experiencing a tech boom.

Becoming more virtual

To return to the question, then, how and why would one nowadays invest in the average UK high street? In the end it is a matter of infrastructure. If the only way retail can keep pace with e-tail is to become less 'real', more 'virtual', then the high street represents a blank canvas. It is the companies that redraw it, as opposed to those that merely occupy it, that are of the greatest interest.

Rightly or wrongly, the 'old ways' are being marginalised to the point of obsolescence. The game has changed, and those institutions that want to avoid extinction will have to change with it.

This is the survival of the fittest in the truest sense, and the spectacle, though sometimes typically merciless, is likely to be never less than utterly fascinating.

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