Artificial Intelligence – Ephemeral Vs. Durable

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In our last note, we discussed probabilistic thinking and the inherent unpredictably of investment markets over the short term. We also discussed some reasons for optimism, our focus on investing in higher quality assets and long-term thinking.

Indeed, this note covered so much of our core philosophy and approach that I haven't really felt compelled to follow it up with another note, until now that is.

Over the past few months, investor imaginations have been re-kindled once more and we have seen the return of 'animal spirits', with artificial intelligence (AI) grabbing the headlines. The leading AI stocks have experienced some very notable gains this year and not surprisingly we are being asked about our exposure to this new 'mega trend'.

So, what is our response? How do we think about investing in this exciting new area? Well, for a start it is not new; AI and machine learning have been around for some time but the advances we have seen over the past six months are remarkable. It is clear to us that we have seen a breakthrough in computing.

Whilst, we are very wary of investment fads and bubbles, we feel pretty confident in saying AI is not a bubble (at least not yet) and the potential for both the economy and the stock market is very real.

The challenge we face though is that investing in high growth businesses is often a losing game.

High growth businesses are often richly valued and attract very motivated competitors, keen to share in the spoils, such that investors can fall into the trap of paying a high multiple on unsustainably high profits.

We need only look at what happened during the pandemic when investors overpaid for the covid or 'stay at home' beneficiaries and the subsequent declines in the share prices of these previous market darlings.

Now as regular readers know, we believe having a strategic allocation to investing in innovation is warranted.

We have long felt that the economy is undergoing a number of technology-driven changes and we have invested in strategies seeking to identify the beneficiaries.

However, it is important to state that this is not easy, and it has presented challenges over the past year, with strategies more focussed on innovation underperforming markedly in 2022.

Whilst we retain conviction in our preferred strategies, it is a reminder of the importance of having a long-term mindset, as patience can be tested from time to time.

It is also an important reminder of the ever-lurking danger of the ephemeral, and the temptation of investing in the next big thing. Maybe you will invest in the next Apple or Tesla, but the odds are not in your favour in this pursuit.

We have little doubt that AI and machine learning will have a big impact on markets and the economy, but we need to be considered when reflecting on what this means for our portfolios. The societal and socio-economic impacts are also likely to be significant (hopefully that is not too much of an understatement) and no doubt an ongoing source of debate.

From an investing perspective, the challenge is somewhat daunting, given the technical proficiency required to understand the technology. However, it is not insurmountable. We are fortunate to have an experienced in-house research team and access to a number of experts in the field.

Furthermore, it has become increasingly apparent in our conversations over the past few months that this challenge is perhaps best met obliquely or by asking the question in different ways.

For example, instead of asking what is going to change over the next decade, perhaps we should ask what is not going to change? This leads us towards focussing on resilience and durability. It leads us towards companies that have survived and prospered during past technological advances, in areas such as consumer staples, beverages and luxury.

Whilst it may be difficult (or next-to-impossible right now) to identify the long-term winners of advances in AI, we can also ask which companies will supply the winners; who will sell the 'picks and shovels' of the AI goldrush?

We can ask which companies will benefit from the capital that is likely to be invested in the coming decade? This is a much easier question to answer today, with certain companies very well positioned.

Which companies will benefit from AI adoption is another question to pose, with companies in control of proprietary datasets an interesting area of focus.

We can also ask whether there are specialist investors in innovation that we can invest alongside, recognising our own limits and strengths. We believe this is a much more durable approach than trying to pick winners at too early a stage.

Investing with a manager that is taking a diversified approach, investing across a portfolio of businesses, with a dedicated team focussed on innovation, is much more likely to be successful than seeking to invest in individual companies on the cutting edge.

How we approach this challenge, and the questions we should ask, prompts much interesting debate at our investment committees and we have asked whether we are witnessing something transient or not.

We have asked ourselves whether it is really credible to see a technology-driven bull market so quickly after the apparent bursting of a bubble in cryptocurrency and a number of high-growth technology businesses, especially against the background of rising interest rates.

However, our analysis suggest that this is 'real' and whilst we are not trying to time the market or issue any kind of rallying cry to invest in technology, we believe that long-term investors need to consider the implications over the next decade.

We are mindful of the arguments presented by less optimistic investors today, noting that 'AI' stocks have already appreciated significantly, and valuations have expanded. However, when we compare valuations and growth rates for the leading stocks today against past market cycles, we don't see any great cause for concern. We are not suggesting these companies are especially good value, but we don't see unsustainable excess.

Whilst our focus will always be on protecting and growing our clients' capital over the long term, we also need to be aware of the changing nature of the economy and investment markets.

We have always described ourselves as pragmatic optimists and it is through this lens that we approach the fascinating challenges and opportunities we will face over the coming years.

As always, please do not hesitate to contact us to discuss our views further.

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