Brewin Dolphin

Durability and data

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Ian Quigley, Head of Investment Strategy, reflects on recent market strength, the rise of artificial intelligence (AI), and how we're thinking about potential AI 'winners'.

Is AI still leading the way?

Over the past year AI has really captured the imagination of investors and the wallets of 'Big Tech'.

The level of capital expenditure being spent by the large technology companies and the cash flow accruing to semiconductor companies is truly remarkable, and we've been keen to participate in the 'gold rush', owning semiconductor equipment companies or equity strategies invested in the beneficiaries.

However, after a period of very strong gains from leading technology businesses, and with over half of the U.S. market's gain this year attributable to the performance of just five companies, maybe it's time to question the sustainability of this trend.

A lesson from history

To help us with this analysis, we can look at history and some excellent work carried out by Empirical Research Partners. While we should always caveat historical market studies, since 1952 we can identify nine years where market gains have been as concentrated as this year.

So, what happened next?

In subsequent years the average market gain was around 12%, with only two 'down' years. Of course, averages only tell you so much and one of the 'down' years was 2008, which was pretty harrowing.

The point of sharing this data is to challenge the view that we're in the midst of a bubble and that this year's 'narrow' market is a precursor to a major decline.

While parts of the market currently look a little expensive, we don't see the type of market behaviour or valuation extremes that have characterised market bubbles in the past. What's more interesting is after historical periods of market concentration, we often see better relative performance from those who have previously lagged. Perhaps next year we could see a reversal in fortunes for companies outside of the mega caps?

With that said, it's important to recognise that a number of the market leaders today are the most profitable companies in history, and earnings growth has been the major driver of their returns. Food for thought.

The decade of the semiconductor

While we certainly do not proclaim to be experts in AI, there is little doubt in our minds that we are seeing some profound advances in computing, and this will have a major impact on the economy and markets over the next decade.

As noted above, the immediate 'winners' of AI investment have been semiconductor companies and we've seen valuations expand across the sector.

The leading semiconductor companies are incredible, achieving mind-blowing advances in chip design, and it's likely they'll continue to deliver record profits in the year ahead.

However, we should remember that semiconductor capital expenditure is cyclical and while we may be in the middle of a semiconductor 'arms race' right now, there will be bumps along the road and after such a strong period of outperformance it's important to recognise this.

Where do we go from here?

This brings me back to the title of this note, 'durability and data'. We've been considering for some time how we position portfolios for AI – how do we protect and grow portfolios during a period of potentially great change?

This is, of course, a challenging question. Investing in the winners sounds attractive, but supernormal profits attract competition and investing in high-growth businesses is, on average, a losing game with most failing to meet lofty expectations.

Perhaps rather than trying to identify the new vanguard of technology winners, we should think about businesses that will benefit from AI or those that will endure and prosper in most scenarios.

What does 'durability and data' mean?

Let's look at 'durability' first. Investing in durable assets is central to our approach, we are long-term investors, and we want to invest in assets that can generate returns above inflation, for as long as possible.

Strong brands are, to our minds, the epitome of durability, especially luxury, aspirational brands, like Ferrari or Christion Dior. You simply cannot recreate these brands, they are not disruptable in our view.

True luxury brands have fantastic pricing power and will likely generate cash flow for their shareholders for decades to come. As you would expect, these companies aren't cheap, and we need to assess our prospective returns, but as businesses they represent what we like to invest in. They are also likely beneficiaries of AI, in a way that may not seem immediately obvious.

History tells us that technology breakthroughs create wealth, and any number of social studies will tell you that humans like to demonstrate their wealth by purchasing expensive items.

This may seem like a superficial point, but it's inherent to our nature, and we see a bright future for truly luxury brands.

Our other area of focus is 'data'. We believe that businesses that have proprietary data are well positioned for advances in AI.

It's quite possible that AI 'tools' become commoditised, resulting in underwhelming returns for the companies that appear initial winners.

It may well be that better economics accrue for those companies that are best positioned to utilise new technologies. We believe that companies with large datasets will be able to apply AI tools to their data and generate greater insight for their customers, ultimately resulting in higher value customer relationships.

Our preferred data companies will also likely have the potential for margin improvement, as they automate more of their processes with AI tools. The payments businesses, rating agencies and some of the large tech businesses strike us as 'data winners'.

Reacting to AI developments is key

While the current advances will clearly present challenges, most notably job disruption and displacement, we believe we should be optimistic about the potential wealth creation from these technological developments.

Of course, how this wealth is distributed will be an important question for society and policy makers.

From an investing perspective, at a time of increased geopolitical concern, it's uplifting to consider the scenario of higher productivity, growth and real wages that advances in AI could catalyse.

Our key role is, of course, to protect and grow wealth, and this might naturally lead us away from investing in perceived risky areas, like AI, and to be clear we are conservative investors. However, it is incumbent on us to think deeply about what is happening right now and what the impact may be.

Focussing on 'durability and data' seems like the most sensible way to express a positive view on advances in AI, identifying businesses and strategies that should deliver satisfactory returns in most scenarios.

While this is unlikely to be the most exciting article you read about AI this year, we hope it gives you some insight into our thinking.

As ever, if you would like to discuss our views further, please do not hesitate to contact us.

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