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Equity Market Commentary

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A question I hear often:

"Is Ai in a bubble?"

1 The analogy is always to the "dot.com" bubble of the late 1990s/early 2000s.

2 What's important to remember is that "the Internet" itself was never in a bubble.

I am quite sure that all of us use the Internet far more than we did on March 24, 2000, when the NASDAQ and Internet stocks collectively hit their epic peak price levels.[1]

3 So, the question is not if <u>Ai</u> is in a bubble.

I am highly confident that the use of Ai will be far more extensive in 10 years than it is today.

4 Yet stocks are forward looking and can overestimate the magnitude of any technological innovation.

As they did into the NASDAQ peak in 2000.

Therefore, the question really is:

Are the Ai *<u>stocks</u>* in a bubble (that is about to burst)?

5 There are two key ingredients for a bubble to exist:

1. *Expectations* of fundamental revenue and earnings growth are too high.
2. Excessive *valuation* multiples are applied to those fundamental drivers.

[1] The NASDAQ did not regain that level until April 2015.

The index performance is provided for illustrative purposes only and is not meant to depict the performance of a specific investment. **Past performance is no guarantee of future results.**

6 In my opinion, it's easier to identify lofty valuations than to identify whether expectations are ahead of fundamentals.

7 So, let's first address the easier question: *valuation.*

There is an "Ai beneficiaries" basket of stocks.

These are companies that are profiting from the hyperscalers' massive capital expenditure to build out Ai infrastructure.

The basket includes semiconductors, memory chips, networking, and other equipment providers.

In perusing this list and *focusing on forward P/Es, I find numerous very reasonably priced companies.*

Seemingly, the ones with the lowest P/Es have historically had the most cyclicality to their earnings.

8 If investors are paying reasonably low valuations for cyclical earnings, that strikes me as *rational behavior*.

They are wary that these *could* be cyclically high earnings.

Bubbles do not peak in rationality.

This is a very different scenario than the dot.com bubble peak.

Back then technology stocks, even those with cyclical earnings, were priced at significantly higher valuations.

9 But what about the more difficult question to ask:

Are investors' *expectations of fundamental growth* overly optimistic?

I will let you in on a little secret:

Nobody is very good at predicting that.

Not even Wall Street.

10 Here is how I know.

Look at the positive revenue and earnings revisions over the last 12 months for the companies in the Ai beneficiaries basket.

The revisions have been massive.

Wall Street has significantly underestimated the fundamental improvement in the Ai beneficiaries' businesses.

And so far, there is no sign of a letup.

Eventually there will be, but in the meantime, we'll be studying revisions for any sign of a peak.

While there are unquestionably many who think they are smart enough to call the top of the Ai spending cycle, I certainly do not think I am.

In my opinion, you will be best served to assume nobody else is either.

11 As I have articulated all year, I am a believer that the Ai investment cycle will last *longer* than many of the pundits suggest for four simple reasons:

1. Ai is a productivity and *cost savings tool*.

   Many companies in numerous industries are beginning to talk about their tangible return on investments.

That will likely continue to grow.

2. Ai usage is growing faster than capacity.

   Capacity expansion cannot keep up.

3. Capex investments are generating strong returns for the large hyperscalers, and the OBBBA[2] bonus of a depreciation tax shield on capex (and R&D) only encourages *further* investment.

4. As I have highlighted previously, the smartest, most successful technological leaders are largely all saying the same thing:

   Ai will be much bigger than many believe or can imagine.

   I think it would be foolish (*or arrogant*) to bet against those who know more about this than I do (or probably 99% of investors).

12 While my conclusion is that we are NOT in an Ai bubble, that does not mean investors are immune *to sharp corrections in the Ai beneficiaries' stocks.*

We see two types of investors in this group.

1. Believers in the Ai buildout and the fundamental merits to investing in these stocks.

2. Investors who are buying Ai beneficiaries purely because prices are going up and they want to chase momentum.[3]

The second group is concerning.

The momentum basket is becoming *crowded* with Ai beneficiaries' stocks.

13 When a basket of stocks captures the zeitgeist of the momentum players, that means there are a group of investors who can and will turn tail quickly at the slightest sign of price weakness.

They are not believers in the fundamental merits of the companies.

14 Then how does the Applied Equity Team capture the potential Ai upside while defending against the dangers of overconcentration?

<u>*We believe there is merit to holding on to a sizable allocation of these stocks within the Applied Equity portfolios.*</u>

However, as a long-only, core equity manager, we also focus on positions that are <u>*not correlated*</u> to the Ai beneficiaries basket.

We are also believers that there are other companies with excellent fundamentals..

I am not suggesting portfolio diversification[4] through the number of holdings.

That implies a portfolio with lots of stocks.

[2] One Big Beautiful Bill Act.

[3] I was in our company kitchen the other day and overheard a recent college graduate in another department declare that he was buying the "DRAM" ETF. When I asked him if he knew what stocks were in that ETF, his response was: "*I have no idea.*"

[4] Diversification does not eliminate the risk of loss.

A classic failure of active management.

15 *Rather, we hold stocks with solid fundamentals that could act as a buffer when the momentum players panic.*

16 To be clear, when the market is consumed singularly with the Ai trade, AEA's non-correlated stocks will *weigh on performance*.

However, when the market suffers from a momentum unwind, as we have experienced in June, the non-correlated stocks can help cushion the pain.

Corrections are painful but nothing like bubbles bursting.

17 As much as I don't think Ai is in bubble territory, there is one thing that could cause a correction to be far more painful.

The Federal Reserve.

Changes in Fed policy can significantly alter the direction of equities.

If the Fed were to change policy and begin raising rates, that would lead us to reduce our Ai exposure.

That is not our base case, but allow me one more secret:

Wall Street, and even the Fed, are not very good at predicting the future interest rate policy direction!

So, we will be watching.

That keeps me up at night.

18 Finally, there is one more question I hear often:

Is it time to buy depressed software stocks?

My response:

Tread lightly.

19 Software seems to be a primary victim of this new era of technological innovation.

As was the newspaper industry when it became apparent that the Internet would disrupt and drive down the consumption cost of the news flow.

While surely not all software stocks will be put out of business, I am old enough to remember all the interest in bottom fishing the newspaper stocks as they declined.

That was largely a money losing move.

20 *My belief - stick with the Ai stocks and a healthy allocation to other non-correlated, non-technology sector themes.*

Andrew

Risk Considerations

Diversification does not eliminate the risk of loss. There is no assurance that a portfolio will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and may therefore be less that what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this portfolio may be subject to certain additional risks. In general, equities securities' values also fluctuate in response to activities specific to a company. Stocks of **small- and medium-capitalization** companies entail special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. Investments in **foreign markets** entail special risks such as currency, political, economic, market and liquidity risks. **Illiquid securities** may be more difficult to sell and value than publicly traded securities (liquidity risks). Non-diversified portfolios often invest in a more limited number of issuers. As such, changes in the financial condition or market value of a single issuer may cause greater volatility. **Ai:** Investing in companies in anticipation of a catalyst event, such as AI adoption, carries the risk that such catalysts may not occur, may be delayed, or that the market may react differently than expected. Companies focused on AI may have limited product lines, markets or financial resources, and their management and performance may be particularly impacted by events that adversely affect AI adoption, such as rapid changes in product technology cycles, product obsolescence, government regulation, cybersecurity concerns and competition.

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