Equity Perspective from the Investment Advisory Group

Artificial Intelligence – Less Shock, Same Awe

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D. Scott Yuschak, CFA
Managing Director,
Equity Strategies

What happened

At the start of the year, Artificial Intelligence (AI) was something most people associated with the future – something in the laboratory. The launch of ChatGPT changed the narrative on the topic, impacting both computing and investing.

AI took the world by storm in the spring with companies involved in the powerful technology reporting earnings that shocked and awed the market. Fast forward three months to the latest round of earnings results and, while we still are awed by the growth, there is less shock. Expectations have quickly adjusted.

Our take

It is important to keep a balanced perspective when it comes to investing in AI. We still expect it to be the most important, transformative advance in technology over the coming decade, but investing in it requires assessing the balance between reality and expectations.

The challenge investors have in the current environment is not necessarily valuation. There is a lot of growth potential based on AI. The challenge comes in assessing sentiment. This is an environment where the magnitude of the upside surprise drives stock prices.

The good news is AI investment remains in its infancy; we have no fear of missing out. We focus on AI investment by looking at three major categories, infrastructure, integration, and end users. It is important to note that many companies fall into multiple classifications. Additionally, customers also will compete with their suppliers.

- **Infrastructure** - The AI environment needs to be built. This has been the biggest focus in 2023. AI infrastructure requires massive scale, which includes capital, real estate, and computing power. The infrastructure is the first piece of the puzzle. You cannot begin to build the tools without the hardware.
- **Integration** - Companies that look to incorporate AI tools into their existing products for use by their customers. These help deliver all the promised virtues of Artificial Intelligence. This group includes large cloud providers as well as productivity software vendors. We see an initial uptake of AI in companies that produce products that look to improve outcomes as opposed to fixing an existing problem. This includes digital

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advertising, sales, and marketing campaigns where there is room for trial and error, where there is art versus just science.

- **End Users** - Companies that will use AI with the goal of increasing revenues, decreasing costs, or both. Many of these companies will be outside of the technology industry, for example manufacturing or logistics companies that often operate on very low margins. These are companies that will spend time running AI in parallel to existing operations or run AI using data from the past. It will take more time for these companies to turn over the keys to AI processes due to the power of the new technology. However, companies believe AI brings a substantial first mover advantage with it, so striking the right balance will be crucial.

In our view, now is the time investors should be looking beyond the infrastructure companies for investment ideas. This does not mean these initial investments should be exited, merely we recommend looking at firms that will integrate AI into existing products. It is still too early to look for AI winners and losers outside of the broader technology arena, in our opinion.

Assessing the AI investing landscape in its current state requires an understanding of the economic environment. The past few years have seen supply line bottlenecks across the globe, impacting almost every industry. The secular growth of semiconductors into more and more products, from autos to kitchen appliances to robotics, only exacerbated these challenges. With uncertainty surrounding economic growth, companies are now willing to work through the inventory they spent the past two years stockpiling.

The semiconductor companies have worked through their backlogs, and in some instances, are seeing lower demand, which serves to slow their orders, freeing up supply. This has cleared bottlenecks for companies selling chips that go into data centers and AI, which has led to a significant increase in sales.

While it is difficult to predict when this initial infrastructure investment phase takes a pause, investor sentiment is easier to gauge. Google showed a very large spike in the search term “artificial intelligence” in the spring. This metric has since leveled off and is now well below April’s peak. Therefore, it is understandable that continued strength in reported earnings could be met with comparatively less investor enthusiasm now and going forward.

Bottom line

Artificial intelligence remains an exciting new development in the economy and the investment landscape. We believe the companies that provide the hardware for AI will remain good investments for the foreseeable future. However, looking beyond the early winners is crucial to continued success. We see patience and diversification as two important virtues when investing in AI.

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