The Growth Opportunities Available from AI

Why Consider Artificial Intelligence?

Artificial intelligence, or AI, has become far more sophisticated in recent years, creating both disruption and opportunity. It brings risk, but there will be winners. We seek to support investors in their understanding of this space.

Key Takeaways

- As a theme, AI has seen significant investor interest and large inflows. The top 10 companies leading the way globally have quickly become household names. We offer new data to help investors understand the leaders in this space.
- As AI is implemented by companies of all shapes and sizes, we could see profit margin expansion, but it carries risk too. Obsolescence is a headline risk, but hidden risks can expose themselves at a portfolio level too.
- Share prices have run up quickly for many AI-focused companies and now carry lofty valuations. On our analysis, second-derivative plays look to provide better opportunity.

Turning Ideas into Actions for 2024

Second-Derivative Plays: Rather than focusing on the big AI players, we see potential opportunity in the next rung of AI adopters. This includes those who can strengthen their products using AI, without the valuation risk.

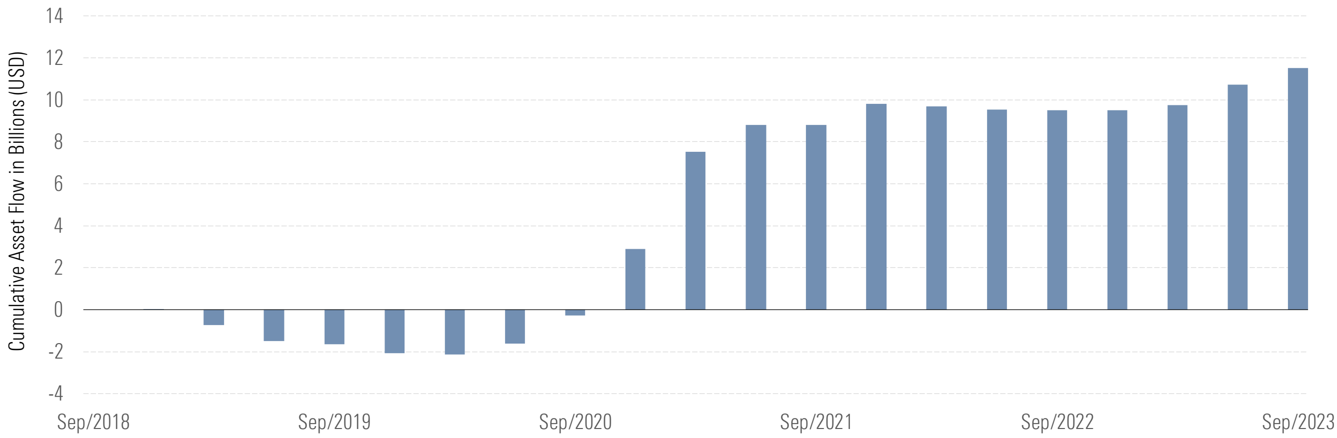
Beware Ultra-High Valuations: As prices have already run up very quickly, there is an embedded expectation of strong growth priced in. As competition rises, we could see disappointments.

Focus on Behaviour: Investors have a bad record of timing their entry into and out of thematic funds. If you find yourself tempted to chase the AI theme, make sure you are aware of your own behaviour.

Taking Stock of the AI Landscape

Artificial intelligence (AI) is largely expected to change the way business is conducted, especially with the progression in generative AI. The pace of change is remarkable, with investors naturally eager to understand the winners and losers. While we'd warn investors not to let hype dominate their investment decisions, we are seeing a tremendous shift in the make-up of equity markets, which are worthy of note for all investor types.

Exhibit Cumulative Flows into AI & Big Data Thematic Funds Globally Over Last Five Years



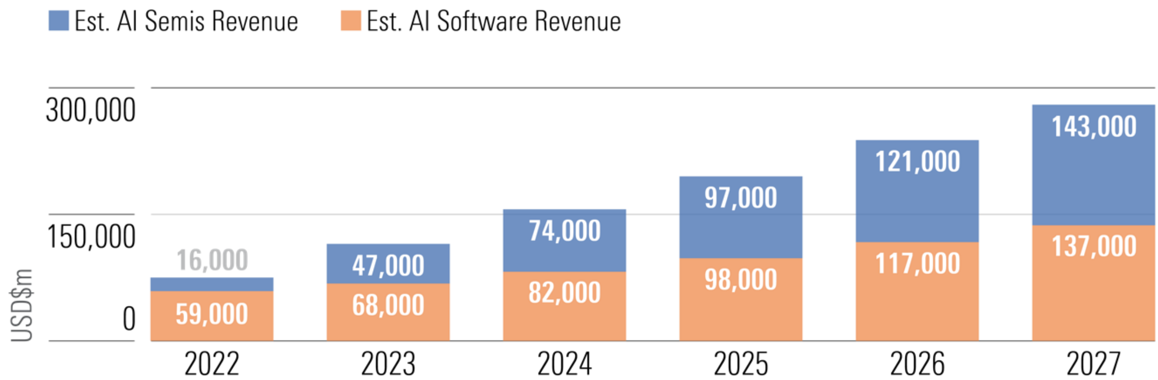
Source: Morningstar Direct, Morningstar Global Thematic Database. Data as of 30 September 2023. For illustrative purposes only.

What, How, Who, and Why?

By now, the majority of people have seen the power of AI first-hand. We expect 2024 to be a year of phenomenal change in this space, with rife competition and practically every company in the world seeking to understand opportunities for automation or growth.

- **What does AI solve?** We see two streams that are additive to company performance. The first is automation, creating efficiencies in the back-office and process improvements. The second is product and service enhancement, potentially creating new revenue growth opportunities.
- **How do we expect it to be used?** Anecdotally, back-office efficiency is the primary motive for most large companies at this stage. However, we expect generative AI and predictive analytics to play a greater role across practically every business function and industry.
- **Who will be using it?** With only a small dose of imagination, we can quickly identify use cases for over 90% of the workforce in developed and many emerging markets.
- **Why is everyone chasing this theme?** This technology offers a significant opportunity to grow profit margins at little cost. There is a race for market share.

Exhibit Between AI Semis and Software, A Long Growth Runway Lies Ahead



Source: Morningstar, Company Documents. Data as of 3 October 2023. Data presented is indicative and for illustrative purposes.

Exhibit The Top 10 Stocks Held in Artificial Intelligence and Big Data ETFs and Mutual Funds Globally

Name	Ticker	Sector	Morningstar Star Rating	Economic Moat
NVIDIA Corp	NVDA	Technology	★★★	Wide
Microsoft Corp	MSFT	Technology	★★★	Wide
Alphabet Inc Class A	GOOGL	Communication Services	★★★★	Wide
Amazon.com Inc	AMZN	Consumer Cyclical	★★★	Wide
Advanced Micro Devices Inc	AMD	Technology	★★★	Narrow
Tesla Inc	TSLA	Consumer Cyclical	★★★	Narrow
ServiceNow Inc	NOW	Technology	★★★	Wide
Meta Platforms Inc Class A	META	Communication Services	★★★	Wide
Taiwan Semiconductor Manufacturing Co Ltd ADR	TSM	Technology	★★★★★	Wide
Snowflake Inc Ordinary Shares - Class A	SNOW	Technology	★★★★	None

Source: Morningstar Direct, Global Thematic Database, Star Rating and Economic Moat Data as of 31 October 2023.

The list of major players in the AI space are already household names, but valuations have increased significantly in anticipation of success. They have a first-mover advantage, although they are still subject to risk.

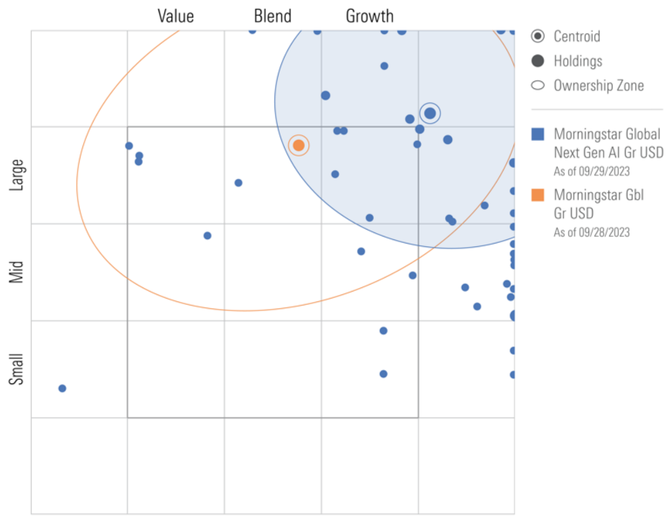
Risks to be Aware of in AI Stocks

Regarding investment risks, AI does bring some new challenges to the table.

- **Regulation and safety.** Let's start with the risk of artificial intelligence itself. The technological capabilities are under immense scrutiny from governments and regulators. While it is widely acknowledged as a force for good, it also creates significant threats. We do expect regulation, although this will be regional and the big policy changes are likely to come in 2025.
- **Valuation.** Even fast-growing businesses can be poor investments if investors overpay for shares. It's also important to keep in mind that the largest portion of a growth company's value is derived from cash flows generated many years in the future. Companies that develop durable competitive advantages are more likely to sustain long-term free cash flow growth and could warrant richer valuations.

  However, this is a very expensive race with significant uncertainty about who the future winners and losers will be. A lot has to go right for the primary-AI stocks to continue to deliver, which could happen, but the risk-to-reward can deteriorate if investors overpay.
- **Concentration.** As with any emerging technology trend, AI brings new uncertainties to companies and industries. As investors, we should acknowledge this higher level of uncertainty when considering position sizes.
- **Obsolescence.** It's far too early to confidently identify companies that will see their products and services become less relevant because of AI. Still, AI will likely bring change to many industries, and we should remain alert to potential shifts in a firm's industry structure. We're equally skeptical of company managers who downplay AI risks as we are those who overhype AI benefits.
- **Hidden portfolio risks.** Even well-informed investors have limited insight into the distant future. We shouldn't assume that because a company seems insulated from AI risks today that it will remain protected in five years' time. Further, investing heavily in AI-related companies can also bring significant portfolio tilts that could adversely alter the reward-for-risk in a total portfolio context.

Exhibit Know What You're Buying: At a Portfolio Level, Beware of Significant Style Biases



	Value	Blend	Growth
Large	7	16	60
Mid	0	1	15
Small	0	0	2

Weight %: 50+ / 25–49 / 10–24 / 0–9

Source: Morningstar Direct. Morningstar Global Next Generation Artificial Intelligence Index. Data as of 31 October 2023.

The AI Opportunity Entering 2024: Second-Derivative Plays

While the excitement surrounding the potential for artificial intelligence has boosted those stocks directly tied to AI, we think some of the more attractive undervalued opportunities are those that are second derivative plays on AI.

Here are four examples that we'd describe as second-derivative plays:

- Most companies do not have the expertise or financial wherewithal to build and maintain their own AI platforms. That's where IT consulting companies could come in with technical capabilities in artificial intelligence services.
- Another example is data management providers that host enterprise data on which artificial intelligence models are run.
- AI requires extremely high speeds to train its data models and we expect those with the highest networking speeds to allow it to reap the benefits of spending brought on by investments in generative AI.
- Data centers will likely experience a long tailwind from the explosion of growth in AI. As AI is built, trained, and rolled out, it will require a great deal of computing power and data storage.

A Focus on Economic Moats Could be a Sensible Approach

In periods where product development is in over-drive, it is a dangerous game to chase the winners. A more sensible approach would ordinarily be to focus on durable competitive advantages.

Companies with economic moats could be more likely to benefit and may be less susceptible to disruption from AI than those without moats. Moats based on a combination of customer switching costs, unique data sets and brands could be particularly valuable. Companies with durable advantages could use AI to improve their products and services and strengthen their competitive positions. On the other hand, change brought about by AI could erode companies' economic moats or shift consumer demand away from their products and services. Investors should be on the lookout for permanent changes in industry structures and customer preferences.

In the end, stronger management teams who allocate capital effectively could influence better investment outcomes. Effectively integrating AI into existing products and services will be a complex endeavor for managers. Navigating new competitive threats will require sound strategy and solid execution. Moreover, managers may be tempted to overspend on AI-related product development or pursue ill-advised acquisitions. Consider investing in businesses whose managers have a track record of sensible capital allocation and effective execution.

Actions for Fund Selectors Who Want AI Exposure

Investors may also use funds as a tool to gain exposure to the artificial intelligence theme. These have multiplied in number and now investors can choose from a veritable smorgasbord of options.

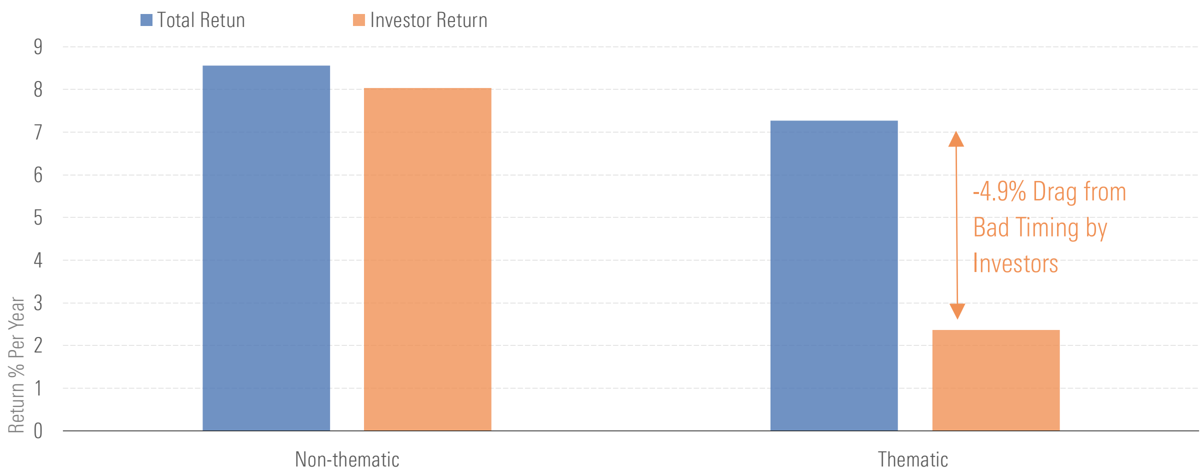
A look back at the commercialisation of technologies in the past shows that picking the eventual winners can be anything but straightforward. For example, in 2007, the year the iPhone launched, Nokia sold almost 40% of the world's mobile phone handsets. It is equally as likely that some of the biggest winners in AI will not be those the markets have crowned today. Buying a thematic fund, rather than a single stock means you are less likely to entirely miss the biggest winners.

When running the ruler over thematic funds, the fundamental fund characteristics that boost the chances of achieving long-term investment success, such as low fees, a seasoned management team, and a trusted parent organisation, still apply equally and should form the foundation of any evaluation. That said, the distinctive characteristics of thematic funds mean a more tailored approach to due diligence is required. One manager may build a high-conviction portfolio of stocks selected for their high growth potential, while another may track the same theme by building a broader portfolio of stocks based on their exposure to a theme and integrating other investment metrics such as quality screens into the portfolio-construction process, which will result in a strikingly different exposure.

Looking beyond a name to really understand how a fund targets its theme is even more crucial when it comes to AI. By glancing at a fund name it may not be straight forward to determine if the fund manager uses artificial intelligence to select stocks or if they are selecting stocks exposed to AI (or on the occasion where they do both).

The volatile return profiles of many thematic funds, coupled with low- or no-commission trading and the intra-day trading capabilities of thematic ETFs, can encourage the worst type of investor behaviour, and ultimately result in poor investment outcomes. Findings in our recent study, The Big Shortfall, show that on aggregate, poor investor buying and selling habits connected with thematic funds over the last five years have destroyed most of the returns provided by thematic funds. It goes to show, you can pick the right theme and right fund, but if you use them in the wrong way you can still end up empty handed.

Exhibit Investors Have a Bad Track Record of Timing the Entry and Exit of Thematic Funds



Source: Morningstar Direct, Morningstar Global Thematic Research Database. 5-Year Total Returns, Investor Returns and Return Gap for Thematic and Non-Thematic Funds. Investor return is the asset-weighted return, adjusted for inflows/outflows. It shows the net impact of buying high and selling low. Data as of 30 June 2023. Domiciles included in this chart: Ireland, Luxembourg, United Kingdom, and the United States.

The AI Punchline

Artificial intelligence is an exciting theme and we expect a lot of market interest in 2024. One effective way to access the AI theme without paying huge valuation premiums is via second-derivative plays. These are not the chip makers or those that offer technology interfaces, but rather, those who can effectively embed AI into their workflow and drive new revenue growth opportunities. The principles of good investing still apply.

Since its original publication, this piece may have been edited to reflect the regulatory requirements of regions outside of the country it was originally published in.

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