It’s Time to Talk About AI

Last year was an almost universally positive year for financial markets. Despite a significant downturn when the tariffs were first announced, US stocks rebounded and enjoyed solid gains. Meanwhile, International & Emerging Markets stocks had their strongest performance in years, providing a boost to globally diversified portfolios. While the stock rally was broad based in many countries and industries, there is clear excitement building among investors around AI and its potential to stimulate future growth.

The general Artificial Intelligence investment thesis is something like this: AI is a game-changing technology that will completely transform our society and our economy. Therefore, companies that are leading the AI revolution will enjoy exponential profit growth. This is actually a common investment thesis throughout history, and past generations have simply replaced “AI” with “electricity”, “industrialization”, “trains”, “automobiles”, or “computers and the internet”. In each of these cases, the first part of the thesis was undoubtedly true – each of these technologies did transform society and our economy. Today we will look at the second part of the thesis: that investors correctly predicted which companies would reap the economic benefits.

Fortunately, the development of computers and the internet around the turn of the millennium offers a wonderful example for comparative purposes. These new technologies were clearly going to reshape our society and our economy, and investors expected the companies driving that transformation to reap the financial rewards. In fact, of the 20 largest companies at the turn of the millennium, 10 of them were computer/internet companies.

Rank (Market Cap)	Company	Market Cap (Billion USD)
1	Microsoft	$604
3	Cisco Systems	$355
6	Intel	$274
7	Lucent Technologies	$236
9	IBM	$192
11	Oracle	$158
15	MCI Worldcom	$152
18	Sun Microsystems	$135
19	HP Computers	$114
20	Dell	$96

Source: www.companiesmarketcap.com

At that moment in time, these were certainly not among the most profitable companies in the US. Instead, they were highly priced because they were seen as the ten companies most integral to the coming computer/internet age. Here is what financial markets think of each of these companies today.

Company	2000 Market Cap (Billions)	Current Market Cap (Billions)	% Change
Microsoft	$604	$3,625	500%
Cisco Systems	$355	$309	-13%
Intel	$274	$173	-37%
Lucent Technologies	$236	Sold for $13.4 (B) in 2006	-94%
IBM	$192	$285	48%
Oracle	$158	$569	260%
MCI Worldcom	$152	Declared bankrupcy in 2002	-100%
Sun Microsystems	$135	Sold for $7.4 (B) in 2010	-95%
HP Computers	$114	$22	-81%
Dell	$96	Sold for $24.9 (B) in 2013	-74%

Source: www.companiesmarketcap.com; Wikipedia (Acquisitions/Bankruptcy); Dell

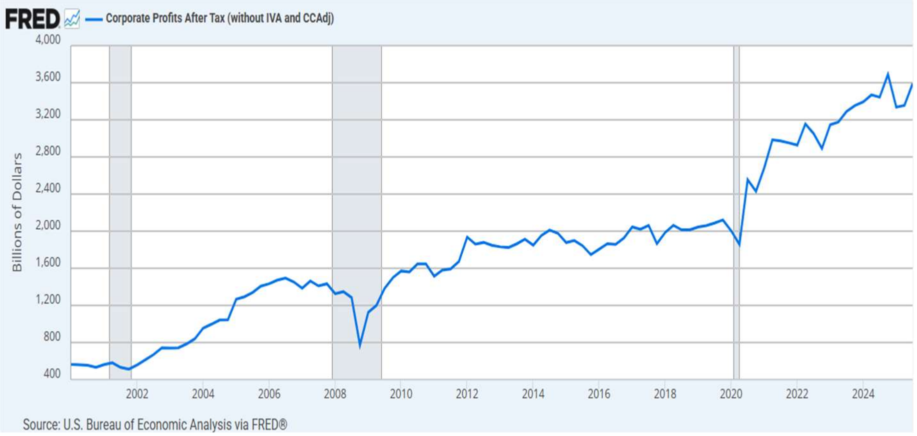
The chart shows a disappointing track record in the subsequent 25 years. Two companies grew admirably, others treaded water, some are shadows of their former selves, and some were sold for pennies on the dollar. In terms of stock performance, only two of the ten companies managed to outperform the S&P 500 (Microsoft & Oracle).

There are two possible logical explanations for this mixed but mostly lackluster performance.

1) The original thesis was wrong, and the technology wasn’t as game-changing as expected.
2) Investors were incorrect in predicting which companies would benefit the most.

Let’s start with #1. Common sense tells us that is wrong, as our own experience shows us that computers and the internet really did transform both society and the economy. Furthermore, many of today’s largest companies are in fact computer or internet (Tech) companies (Amazon, Apple, Meta, Google, & NVIDIA); they are just not the ones that markets valued the most back in 2000.

Finally, the macro-level data completely supports the original thesis. Corporate profits have exploded, growing more than 500% over the past 25 years (as has the US stock market as a whole).



Source: U.S. Bureau of Economic Analysis via FRED®

Source: St. Louis Federal Reserve

While it is impossible to pinpoint how much of this expansion was directly the result of computers and the internet, economists agree that these technological advancements significantly boosted productivity and growth.

Clearly, the first part of the investment thesis was correct; the new exciting technology *did* spur exponential profit growth and stock market gains. This leaves us with explanation #2: investors failed to correctly predict *which* companies would enjoy most of that growth.

In fairness to investors from 25 years ago, correctly predicting which stocks will outperform the market over long periods of time is incredibly difficult, hence the importance of diversification. Additionally, the dot-com era was famous for just how incorrect investors were, and how big a price they paid for it. This single example does not necessarily imply that every emerging technology will follow the same path. However, it is an important lesson in humility, and there are some notable comparisons to today's AI companies.

Specifically,

1) Once again we are witnessing an exciting new technology that will almost certainly increase productivity and boost economic growth
2) Once again, 10 of the largest 20 companies in the S&P 500 are the leaders of this new industry
3) Once again, those 10 companies have much higher valuations than their current earnings can justify, meaning their stocks are priced based on expectations of exponential future growth

Despite these similarities, there are also reasons for optimism. In fact, there are several strong arguments why AI may be inherently different:

1) Today's top AI companies are already enormously profitable
2) AI requires a scale of investment that only certain large companies are capable of, making it easier to predict winners
3) The magnitude of the growth potential from AI may be much larger than the growth that resulted from computers and the internet

The point here is not to predict that history will repeat itself. The point is that smart investing requires having the awareness to recognize that it is possible. We believe in the first part of the AI investment thesis: it is a game-changing technology that will transform our economy and potentially generate exponential economic growth. It is possible the current AI giants will continue their incredible growth trajectories. Conversely, it is possible we will end up with a bunch of similar AI products that compete on price, lowering AI company profit margins, and passing along most of the economic benefits to their customers (all the "regular" non-AI companies out there). It is also possible that the eventual winners will be companies that are not currently on our radar, or do not even exist yet. We cannot predict which of these scenarios will come true, but being diversified investors means we can ensure we capture the growth within our portfolios, wherever that growth ends up coming from.

This material is intended to be educational in nature, and not as a recommendation of any particular strategy, approach, product or concept for any particular advisor or client. These materials are not intended as any form of substitute for individualized investment advice. The discussion is general in nature, and therefore not intended to recommend or endorse any asset class, security, or technical aspect of any security for the purpose of allowing a reader to use the approach on their own. Past performance is not indicative of future results. Before participating in any investment program or making any investment, clients as well as all other readers are encouraged to consult with their own professional advisers, including investment advisers and tax advisors. Any charts, graphs, or visual aids presented herein are intended to demonstrate concepts more fully discussed by your investment advisor, and which cannot be fully explained without the assistance of a professional from North Woods.