Epoch Investment Partners, Inc.

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MEDIA RELEASE

AI mania driving investment decisions, but don't forget fundamentals

2023 has seen AI mania captivate investors, as a year-to-date bull run in global equities has been fuelled by rampant speculation on the future growth implications of the technology's broad adoption however rising market indexes paint a somewhat misleading picture, says Kera Van Valen, portfolio manager for the Global Equity Shareholder Yield strategy at Epoch Investment Partners (TD Epoch).

The year's rally has been remarkably concentrated, being largely confined to just a handful of mega-cap tech companies," Van Valen says.

"Recent years have seen these firms' index weights balloon alongside their price multiples and market caps; for example, Microsoft and Apple now make up nearly 10 per cent of the MSCI World Index, which is composed of over 1,500 stocks. High index weights coupled with outsized returns have led to just 7 stocks accounting for over 50 per cent of the MSCI World's return through the end of the second quarter."

Van Valen says the narrow market leadership poses a relative performance challenge for diversified equity managers.

"Indices meant to be representative of the broad market have seen their return profiles skew due to these concentrated position sizes, which presents difficulties for managers like us who emphasise the benefits of diversification in their risk framework and portfolio construction process."

Managers who are focused on income have found the year's market environment less supportive as well, says Van Valen.

"From an income perspective, it's difficult since most of the tech companies leading this AI rally are growth oriented and don't pay dividends."

That said, while the AI trend has rewarded a small cohort of tech stocks most sharply, there are other pockets of the market benefiting from the theme. Van Valen notes that her portfolio is not absent exposure to AI and has seen ample participation in the year's rally; however, she highlights the importance of not losing sight of fundamentals.

"The stocks that have been center stage during this rally have seen their valuations skyrocket based largely on lofty expectations of future growth; however, there is limited fundamental backing right now. It will be important to watch how earnings unfold over the next several quarters."

The Global Equity Shareholder Yield Fund's positive net absolute return this year has been driven largely by its holdings in the information technology sector. The fund focuses on owning fundamentally strong, highly cash generative firms that prioritize returning cash to shareholders, and holdings that are thematically linked to AI are no different.

"One portfolio holding with exposure to the AI theme is Broadcom, a designer and manufacturer of digital and analog semiconductors focused on connectivity. The stock has benefitted from growing expectations for needed investment in networking to support nascent use cases surrounding generative AI. The company returns cash to shareholders via an attractive dividend with a target of paying out 50 per cent of free cash flow."

Despite the buzz and market chatter, investors should remain cautious when chasing the most crowded AI trades that have already seen valuations pushed to precarious levels. Given the current macro-economic environment—with political uncertainty in the US, high inflation and interest rates, the likelihood of a recession, and the ongoing Russian-Ukrainian war—Van Valen believes the most reliable and best source of returns will likely be shareholder distributions.

"Companies that will outperform are those with strong market positions, a track record of maintaining and growing cash flow through economic cycles, pricing power and the ability to defend margins. We also look at corporate balance sheets that reflect high liquidity levels to support dividends and share repurchase capability.

"While earnings will likely be pressured by the current macro-economic backdrop, companies that hold these characteristics should prove capable of maintaining earnings growth despite the volatile environment," says Van Valen.

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GSFM was established in 2007 as a subsidiary of the Grant Samuel Group. In 2016 Canadian wealth manager CI Financial Corp (CI) purchased an 80 per cent stake in the business, acquiring the stake previously held by Grant Samuel.

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- Payden & Rygel, a Los Angeles based independent investment management firm
- Munro Partners, an independent global equity manager based in Melbourne
- London-based Man Group plc
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