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Seeing Through the AI Haze

AI hype drove a risk-on market rebound in the second quarter despite ongoing hostilities in the Middle East. Equity market prices continued fluctuating with AI and "value" stocks see-sawing daily. One group often lags the other or may be down while the other is up. Then, the next day leadership reverses. To confuse matters further, former value stocks such as memory chip makers became AI darlings while certain members of the so-called Mag 7 descended into the value sphere.

The promise and fears associated with AI have in our view created a speculative haze. Epic coding feats are as common as erroneous presentations of fact. Investors must squint hard to stay grounded in what is really unfolding. The likely economic realities, though far from settled, are in our view clearer than the confusion posed by market fluctuations and conflicting AI anecdotes. Our economic and financial observations are summarized below.

- US equity market prices remain near all-time highs relative to cyclically adjusted profits. They have been hovering in a range of historic highs the entire decade of the 2020's, which makes this period in US market history a data point of one.

- If there was ever a time to cyclically adjust profits, it is today. The most successful companies in the world are pumping over $800 billion of *additional* capital expenditures into the economy, not only goosing GDP growth, but also converting their costs into the corporate profits of their vendors. The chart which follows this section shows historical trends in earnings and free cash flow per share.

- Generative AI is coming up on four years since its release in the wild. So far there are no signs of either extraordinary productivity gains or mass unemployment at the macroeconomic level. In our view, like the "World Wide Web" of the 1990s, the AI layer will be built over the next decade or two.

- Our continued hope is for generative AI and other forms of machine learning to bend the GDP productivity trajectory from a more recent 1-1½% per annum to its historical long-term rate of ~2%. Greater productivity gains will be needed more than ever to maintain overall growth rates in the face of cresting global populations.

- ACR portfolio companies, based on our valuation and growth assessments, continue to perform well, with Equity Quality Return (EQR) companies tracking above historical fundamentals in the first half.[1]

- EQR strategy cash has increased to 25% due to continued trimming of positions as prices approach full value. Despite high general market valuations (or perhaps because of them), there are pockets of opportunity in healthcare, food, and perceived AI casualties which we are exploring.

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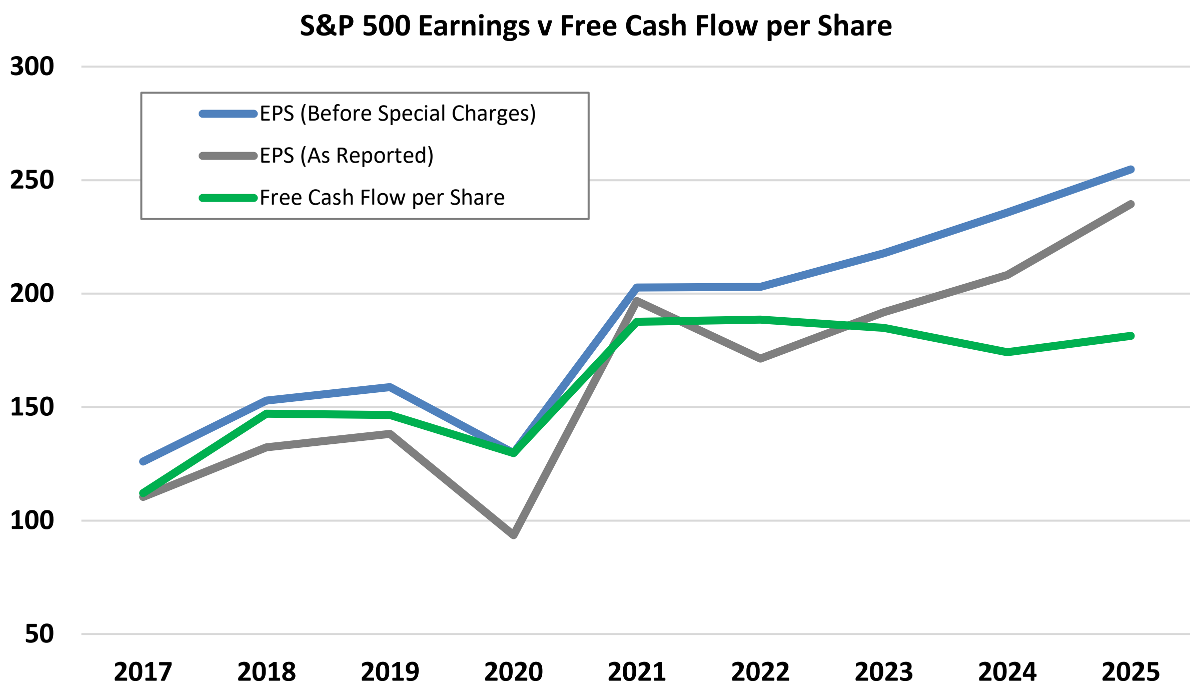

Note: *EPS (Before Special Charges), EPS (As Reported), and Free Cash Flow per Share are sourced from S&P Capital IQ from 2017-2025. Free Cash Flow equals cash flow from operations less capital expenditures. Sources: S&P Capital IQ; ACR Alpine Capital Research.*

A widening gap between reported earnings and free cash flow is not necessarily bad, assuming investors understand how heightened capital expenditures can temporarily inflate corporate profits. Capital investment which reduces free cash flow but generates a strong return on capital increases growth. Even investment which produces poor returns on capital but raises worker productivity can be good for the overall economy. The problem today is that we do not yet know whether the massive capital expenditures being invested in AI will accomplish either.

The investment team is spending an inordinate amount of time these days attempting to understand how AI is impacting everything. When the economy is hit with supply and demand shocks, the ACR investment team experiences positive and negative "research shocks". The Internet and AI are examples of positive research shocks. During these times, we spend a lot of time wrapping our heads around a new technology. The Great Financial Crisis and Covid Pandemic were negative research shocks. In these cases, we spent a lot of time assessing the economic carnage we sought to avoid while sifting through the rubble looking for opportunities. Both types of research shocks are fascinating. The negative shocks are a little more fun because there are usually more cheap assets to buy. Yet positive shocks can be fruitful too. The Internet bubble peak in 2000 presented us with terrific opportunities. Today's AI bubble may do just the same.

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During negative economic dislocations, specific assets are often inexpensive on both an absolute and relative basis. In high-priced speculative markets, specific opportunities may be attractive relative to the broader market but only moderately attractive in absolute terms, offering prospective returns that are respectable rather than exceptional. A certain phenomenon in speculative markets creates special opportunities though. As market participants purchase whatever class of securities is favored, they often fund these incremental allocations by selling securities which are out of favor. The out of favor camp generally presents the happiest hunting grounds. The AI era is revealing some unusual potential opportunities in this regard. Not only are some securities considered out of favor because they are not AI beneficiaries, but there are also groups of companies today which have been branded as AI casualties.

Software is exhibit #1. If software was previously eating the world, then AI is now eating software. Software began its rise as the intellectual infrastructure which runs business processes in the 1970s. Venture capitalist Marc Andreessen was, in some ways, late to the party when he declared in 2011 that software was eating the world. For years the rise of minicomputers, PCs, the Internet, Mobile, and Cloud required new and ever-expanding layers of code to help manage and run business and consumer processes. Now imagine increasing the productivity of software development by a factor of ten! A shakeup is in store to say the least. Yet these are early days. One potential irony is that the more revolutionary AI proves to be for business processes, the longer it may take to build out the AI software layer. Changing business processes can take a much longer time than writing code. It will also likely take some time before the places in which generative AI is most useful can be identified and safely built into the existing software stack, even with accelerated development times. There have been many early wins, but there have been at least as many dead ends.

Teasing out beneficiaries and casualties of the AI revolution is no easy task. As we have pointed out previously, this is an industry-by-industry, company-by-company, and product-by-product analytical exercise. It helps when market participants are shooting first and asking questions later, thereby pushing stock prices of many perceived AI casualties materially lower. Nevertheless, adding new positions will take a lot more than an optically cheap stock. Our brand of value investing demands that value grows each year at a sufficient rate as prices move toward full value. As long as we are accumulating value in the form of dividends or per share earning power growth, we have all the patience in the world. Conversely, we have little patience when value is not accumulating at the company level. If a company is not making money, it is losing money.

We are excited about the potential opportunities we are seeing and continue to diligently turn over stones this quarter. Yet no action will be taken until we have a high degree of confidence that an AI casualty has been falsely accused.

Nick Tompras
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1. ACR measures Fundamental Return, defined as dividend yield plus the change in our estimate of fundamental or intrinsic value. YTD through June 30, 2026, the EQR portfolio generated a market return of 8.6% (gross of fees) and a Fundamental Return of 9.4%. Excluding cash holdings, the Fundamental Return of EQR's equity investments was 11.7%.

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The Equity Quality Return (EQR) Total Accounts Composite consists of equity portfolios managed for non-wrap fee and wrap fee clients according to the Firm's published investment policy. The composite investment policy includes the objective of providing satisfactory absolute and relative results in the long run and preserving capital from permanent loss during periods of economic decline. EQR invests only in publicly traded marketable common stocks. Total Return performance includes unrealized gains, realized gains, dividends, interest, and the re-investment of all income. Pure Gross returns are gross of all fees and do not reflect the deduction of transaction costs in wrap portfolios. Pure Gross returns are supplemental information. Net of ACR Fee returns are Pure Gross returns reduced by 1.0% per annum, which is the standard management fee for the Equity Quality Return strategy. Please refer to our full composite performance presentation with disclosures published under the Strategies section of our website at https://acr-invest.com/eqr-advised-sma-composite/

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