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COULD INNOVATION IN ARTICIAL INTELLIGENCE DRIVE THE NEXT WAVE OF PORTFOLIO WINNERS?

Technological change creates winners and losers. Newton's Raj Shant highlights where the best investment opportunities can be found as artificial intelligence looks about to become a reality.

Executive summary

- The World Economic Forum predicts the rise of robots and artificial intelligence will result in a net loss of 5.1 million jobs over the next five years
- The best investment opportunities in this fast-changing world are companies that see how technology is evolving and are quickest to harness the power of technological change.
- Commodity producers are losers in this environment as it is very hard to maintain pricing.
- Service businesses are potential winners in a world of abundance, as are guides and search engines and companies that either drive change or enable people or other businesses to adapt to change.

Weighing up technology

To date, technology has generally been seen as good for productivity and prosperity, but in the next decade people could become much more aware of the downsides of the technological revolution.

Investors often only consider the negative impact of technology when major security breaches hit the headlines. However the next stage of digital development, the transformative adoption of artificial intelligence (AI), could prove even more disruptive than hacking and cybercrime, says Raj Shant, portfolio manager on the global equity team at Newton Investment Management.

"Technology is moving from being able to perform relatively repetitive simple tasks to performing ever more complex functions," says Shant. "There is a race now on to develop technologies that can improve themselves over time. Some argue this will be the last innovation that human beings ever make because beyond that point all the best innovations will come from machines not us."

Humans are still far from producing the kind of learning, conscious machines portrayed in films like Blade Runner or Ex Machina, but there have been huge advances in AI research in recent years. As machines are able to do more information intensive jobs and unstructured roles requiring a higher degree of complexity there is more potential for automation to become a viable alternative in the workplace. At some point that will tip over into AI which could raise potential flashpoints. The World Economic Forum (WEF) predicts the rise of robots and artificial intelligence, part of what it calls the "Fourth Industrial Revolution", will result in a net loss of 5.1 million jobs over the next five years 1.

"Machines have been putting blue collar employees out of work for more than a century," says Shant. "White collar workers who historically thought they were immune to displacement by automation are now in the firing line. This illustrates a dark side to technology, and that is that, in the short run, it often puts people out of work."

The WEF's stark assessment highlights the looming challenge to businesses, and by extension their investors, as technologies displace jobs in industries, from manufacturing to healthcare. The organisation's 'Future of Jobs' report concludes that many businesses are not adequately prepared for the disruptive changes ahead and have been "timid" about taking action to address these challenges so far.

This failure to take action when technological change occurs is not unusual, though some businesses are quicker to adapt than others. How quickly companies adjust is something investors should be aware of, believes Shant, as it may be an indication of future growth potential. “The best investment opportunities are found among those businesses that see how technology is changing , understand it better than their competitors and adapt more quickly to harness the power of those changes,” says Shant.

In a fast-changing world you need to be “much more selective in stock market terms about where you invest.” he adds.

A world of abundance

To help identify the companies that are adapting most successfully to technological change, Newton fund managers can draw on a number of the investment house’s themes. Two of the most relevant being “Mind the Gaps” and “Abundance”.

“We live in a world with more stuff that is more readily available, more cheaply than ever before,” explains Shant. “That implies price pressures, margin pressures and pressures on profitability. New technology combined with super cheap capital, as central bankers implement zero or even negative interest rates, means lots of overcapacity.”

In an interconnected world overcapacity in a sector in one country means overcapacity in that sector anywhere in the world.

“You go to look for something in a shop and you are not sure about the price so you look it up on your smartphone and find you can buy it much cheaper,” explains Shant. “Some apps now allow you to buy directly from Asia. Overcapacity somewhere else in the world is overcapacity right here in any high street in any shop you happen to be standing in. Abundance is leading to bigger gaps.”

That means a loss of pricing power for some companies, though others have proved to be more resilient.

Shant says: “If you are producing something that is easily commoditised, like commodity producers or energy producers, you are a loser in this environment as it is very hard to maintain pricing. Similarly, if you are in any way inefficient or operating with old technology you are very vulnerable in this environment of rapidly changing business models.”

By contrast service businesses are potential winners in this world of abundance if they are able to exploit facets of their service. As commodities get cheaper, services and experiences are getting more expensive.

“Coffee shops provide the best example of the difference between commodities and services,” says Shant. “I visit a coffee shop on my way to work because it is convenient and I would only break that routine if coffee elsewhere was not only better but quite a lot cheaper.”

Because that doesn’t tend to be the case, coffee shop owners have been able to increase prices year after year without much protest from their customers. Coffee prices, however, have been declining because coffee producers lack pricing power. “Coffee producers are easily replaceable,” says Shant. “If you do not match the prices of other coffee providers you will lose out.”

Enabling change

Guides and search engines that help individuals and businesses navigate the vast amounts of information that are now available online should also do well in the world of abundance, says Shant. That means companies like Google’s parent Alphabet or the travel review site Tripadvisor.

“The more information there is the harder it gets to turn it into knowledge. People go to Tripadvisor because they trust they will get a fair and genuine view of what a place is like so it helps them make decisions,” says Shant.

He also highlights enablers, which are businesses that allow other companies to manage, adapt and thrive in the new world. One example being Accenture which helps other companies adapt their IT architecture. The group is also a significant investor in research and development for AI at its Dublin Centre for Innovation2.

“Complexity at every level is far greater than it used to be,” says Shant. “Accenture helps companies understand their business so they can manage it better. It has pricing power because if a potential customer does not like what it charges, Accenture can threaten to walk away and help a competitor.”

Other companies that are either driving change or enabling people or other businesses to adapt to change include the aforementioned Alphabet and German-based SAP, a leading software provider.

Beyond technology

However, investors should not assume that it is only technology companies that are adapting successfully to the new world. Equifax has its origins in a Tennessee grocery store in 1898 so is anything but a brazen Silicon Valley start-up disrupter. For many years it survived and thrived as a credit bureau, providing reports and scores on individuals applying for credit. Then a new management team came in and took a fresh look at its business model and began to rethink it as a data business.

“They looked at new forms of collecting and splicing and dicing data realising that advances in technology meant they could collect more data about more people more quickly than ever before and provide more powerful and predictive tools,” says Shant. “Every aspect of the business has been undergoing transformation though it is not a tech stock.”

The Newton Global Opportunities Fund first added Equifax to its portfolio in 2012. More recently the holding has been sold down as it has become much more expensive, however, Shant says: “essentially it is the same investment idea as it was back then.”

He adds: “You do not need to be investing in the latest technology company to benefit from technological change. We do like technology companies though we do not invest in start-ups because there is a risk that far too many of them will end up worth nothing. Essentially we are agnostic as to where we find opportunities.”

For him, the key is to seek out companies that have found a niche helping other people navigate through all the information that is now available, all the choice we have, or those that enable other companies to adapt to the rapidly changing environment.

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