THE FUTURE STRATEGIST

GLOBAL EQUITIES | NEWSLETTER | Q3 2024

Q3 2024 COMMENT

MARK HAWTIN

The third quarter of 2024 was not a period for the faint hearted. Recent commentary from the likes of David Einhorn at Greenlight Capital suggesting that markets are broken looked prescient as markets whipsawed their way through the summer.

Volatility was everywhere but nowhere more so than for the Nikkei 225 in Japan. If you had been on holiday and done nothing more than check your quarterly valuation, you would wonder what all the fuss was about; the Nikkei ended the quarter up 7.7%. However, intra-quarter volatility was a different story. After a 6.5% rise to 11 July, the Nikkei then fell 25% to early August, including a 17% two-day fall as markets appeared to succumb to a 1987-like liquidity event.

Assets across the world reacted in tandem, with the US SOX semiconductor index in particular falling 25% from peak to trough, reflecting a general move towards derisking of the most crowded trades (in this case the big AI capacity buildout). Even the mega cap constellation saw profit taking and a quarter of underperformance, ending flat as a group against the S&P 500 index being up 5.5%.

At the same time, interest rate markets were reacting violently to the anticipation and the result of a surprise 50 basis points (bps) cut by the Federal Reserve on 18 September. The short end (two year) saw yields fall a whopping 115bps from 4.75% at the start of the quarter to 3.60% at the end. In the commodity space, gold rose 14% in the quarter – for a four-quarter winning run – and to new all-time highs, while oil fell 18%, perhaps taking its cue more from expected global economic weakness than the rising tensions in the Middle East.

All in all, the quarter was an ambiguous juxtaposition of asset price moves that left many wondering what the path to the end of the year would really look like. As the Kobeissi Letter bullet pointed with tongue in cheek, stocks are rising like we are avoiding recession, gold prices are rising like we are heading into recession, oil prices (late in the quarter) are rising like we are heading towards all-out war, bond prices are easing like geopolitical tensions are easing and tech stocks are rising like risk appetite is at all-time highs.

With such a lack of clarity, it normally pays to be more cautious but, as we set out in the outlook section, there are clear ways to generate alpha at the moment in equity markets even if the overall direction is unclear.

AI Agents: Are they the new workforce?

PIERAN MARU

AI is already transforming the way we work, boosting productivity and efficiency. Just as we moved from horses to motorcars or jobs done by hand to computers, AI represents the next generational shift in productivity. During my recent meetings in California with the senior management of over a dozen companies, one term consistently emerged: "AI Agents."

While being a great buzzword for the next generation of AI productivity and support, it is important to understand what an AI Agent really is and who the winners and losers will be. A good starting point is to de-bunk some of the misconceptions between Co-Pilots and AI Agents.

Co-Pilot versus AI Agents: What is What!

With the convergence of large language models (LLMs) and chat interfaces, the creation of Co-Pilots – AI assistants designed to aid productivity and creativity – have seen a rapid rise in usage. Co-Pilots leverage Natural Language Processing to understand and generate text. This process involves breaking down input text into tokens, known as tokenisation, which models then process to generate responses.

Initially, Co-Pilots operated through text, but have since evolved to support multimodal inputs and outputs such as images and videos. Although still in its infancy, scepticism persists due to the currently limited real-world applications for Co-Pilots in an enterprise setting. One notable limitation has been the tendency for Co-Pilots to produce erroneous facts or famously fabricate cases in legal research which have been submitted to court. Grounding is now an option for supported models to reduce model hallucinations and to anchor model responses to verifiable sources of information. Models can be grounded to publicly available data or tethered to specific private datasets, significantly improving accuracy and reliability.

Technically speaking, a Co-Pilot is a type of agent. However, the distinction between Co-Pilots and AI Agents lies in their interaction and autonomy. While Co-Pilots work alongside users, requiring input and interaction, AI Agents can operate autonomously, adapting and learning independently. This autonomy is what makes AI Agents so exciting.

As AI Agents operate totally independently, they are capable of managing complex tasks without continuous human intervention. For example, an AI Agent might manage your calendar, scheduling meetings but also being able to adjust them based on the availability of participants and other priorities, all the time without needing any input except of course where it has learned that you would like to be consulted! It is this adaptability that sets AI Agents aside, and they are designed to learn and adapt. They improve and evolve their behaviour with every interaction, providing better outcomes and dynamically changing with the environment. They will make informed choices by utilising vast amounts of data, streamlining workflows and ensuring the best possible outcomes.

There are limited applications of AI Agents in action today. Intuit, however, the online accounting software provider, has showcased Agent AI-powered workflows to assist in automating cash flow management, such as managing business postings and using specialised AI Agents to orchestrate invoice processing or bill creation. While ServiceNow, the market leading cloud-based software company that manages and optimizes enterprise workflows, envisions agent-to-agent collaboration that could address multi-departmental issues across workflows without the need for human intervention.

We are some way from multifarious use cases. The focus is currently on customer relationship management, think better and more autonomous chatbots for resolving customer interactions. There is also increasing use within various B2B applications where the agents operate in a more walled garden environment that is easier to manage.

Confusion remains around where Co-Pilots end and AI Agents begin, most notably in some industry verticals or consumer facing applications. The table below is an extract from a larger data set published under the heading "The Agent Economy" (Felicis). We highlight in the final column our view on the true classification of these disrupters.

	HORIZONTAL				VERTICAL				CONSUMER		
Role	Employees (US)	Leader	AI examples	Role	Employees (US)	Leader	AI examples	Role	Employees (US)	Leader	AI examples
Sales/SDRs	5,700,000	salesforce	AGENT 11x / AGENT ARTISAN	Lawyer	1,300,000	Thomson Reuters	CO-PILOT Harvey.	Real Estate Agent	1,600,000	Zillow	reAlpha
Bookkeeping/ Accounting	3,300,000	intuit quickbooks	AGENT Jenesys	Financial Analyst (Investments)	818,000	Bloomberg	CO-PILOT linq alpha	Lawyer	1,300,000	LEGALZOOM	VIRTUAL ASSISTANT ailawyer / CHATBOT DoNotPay
Contact Centre Agent	2,860,000	Five9	AGENT parloa / AGENT SIERRA	CPA	572,000	Sage	CO-PILOT taxgpt	Personal Trainer/Coach	350,000	PELOTON	thriveAI
Operations	1,133,202	UiPath	AGENT BREVAN	Construction Project Manager	510,000	PROCORE	RPA runk. tools				
IT Admin	614,000	servicenow	CO-PILOT Espressive								
Chief of Staff/ Exec. Assistant	516,100	Calendly	Blockit AI / CHATBOT mindy								
Marketing	389,000	Adobe	CO-PILOT Jasper								
SRE	50,000	DATADOG	AGENT Cleric								

Source: www.felicis.com/insight/the-agent-economy and Liontrust, October 2024. RPA = Robotic Process Automation. **All use of company logos, images or trademarks in this document are for reference purposes only.**

While some of the new companies in the right hand column are Agent AIs, especially in the horizontal provider category, those in industry verticals and consumer are largely Co-Pilots or RPA companies (Robotic Process Automation). Some even overclaim their ability! Recently, DoNotPay ageed to a $193,000 settlement with the Federal Trade Commission (FTC), after initially claiming to "generate perfectly valid legal documents in no time." DoNotPay stated they would "replace the $200-billion-dollar legal industry with artificial intelligence," however they did not conduct any testing to compare outputs to a human lawyer and did not have any attorneys. The company is now prohibited from making claims about its ability to substitute professional services without any evidence to back it up.

The confusion is such that, for example, reAlpha, an agent in the property investment field, came to the stock exchange in late 2023 (six months after the Nvidia Eureka moment) with disastrous consequences. Hailed as an AI agent with great potential, it conducted a direct listing at $8 per share as the reference price. It opened at $23 and rallied on day one to close at $407!! This left the founder, CEO Giri Devanur, with a paper fortune of $11.2 billion. Days later, the shares had crashed and today the shares trade at $1 and with a market value of just $54 million. This should act as a stark reminder of hype versus reality. We don't doubt the potential but as with all new technologies, care is needed.

RPA is also often confused with Agent AI. This industry sub-sector came to prominence in 2012, and the first high-profile company was Blue Prism listed on the UK Stock Exchange. US companies followed, with the most high profile of these being UI Path that listed in 2022 at a price of $56. It quickly rose to $90 on AI hype but has since fallen back to $12.5, a fall of 86% from the peak. RPA has gone from AI boom to little more than a rules-based assistant.

It is estimated that over time, AI Agent's will resolve 80% of inquiries autonomously, allowing human employees to focus on more complex projects[1], while Gartner predicts that, by 2028, one third of interactions with GenAI services will invoke action models and autonomous agents for task completion.

1. Zendesk: www.zendesk.co.uk/blog/ai-agents/#georedirect

Will AI Agents drive a change in pricing strategies?

With AI's growing impact, the question arises of how AI Agents can monetise the value they create. In the early days of software, perpetual licenses with optional maintenance and support fees were common. However, this model has largely been phased out in favour of a seat-based or consumption-based model or a blend of these two. Seat based offers lower initial costs and greater flexibility for users, whereas usage-based models allow customers to pay based on their actual usage and throughput. With AI Agents, given the cost of compute, a number of companies are experimenting with work-based pricing models. ServiceNow is considering the use of tokens for additional compute resources on top of their existing model. Salesforce recently announced a charge of $2 per conversation handled by its AI agents – helping to mitigate the possible impact of AI agents cannibalising their current model with labour efficiency.

When transformative technologies emerge, they typically attract vast amounts of capital and intense competition. However, caution is necessary. Marc Benioff, CEO and Co-Founder of Salesforce, recently criticised the hype as selling science projects to companies and comparing Microsoft Co-Pilot to the infamous Microsoft Clippy. The opportunity is clear but the speed of adoption is not.

Company valuations can often stray from fundamentals, with an overestimation of return on invested capital by the first movers. As data quality improves and models gain access to private company data, the integration of AI agents into existing workflows will significantly increase productivity and efficiency. This opportunity excites us; we are early in the innings for AI and the real enterprise use cases are just starting to emerge.

Poker and active investing

DAVID GOODMAN

I play poker with a group of friends, all of whom are professionals in various disciplines of work and each is successful in their field. It is clear to me that the participants in trading or risk management roles have an edge at the poker table. Why is this?

The nuanced similarities between active investing and poker are an intriguing study of psychology, strategy and risk. Both activities require intense emotional grit, a good understanding of risk versus reward and an unrelenting dedication to making good decisions in an uncertain environment.

Overcoming uncertainty

Making good decisions in changeable conditions is a powerful skill. Both poker and investing require making decisions with incomplete information; poker players do not know what cards their opponents are holding, while investors cannot predict market movements or fundamental outcomes with certainty.

Poker players use probability and statistics, making informed judgements about betting and folding. Investors use quantitative, qualitative and technical analysis to evaluate investment opportunities and manage risk.

Effective risk management is crucial in both fields. Poker players manage their bankroll to stay in the game, while investors diversify their portfolios and use hedging strategies to protect against losses. Both disciplines do not run from danger, instead they learn to analyse chances and spot patterns to make well-informed choices.

Using process to make good decisions

Knowing when to fold, call or raise in poker depends on the cards you are dealt and the actions of your opponents. Knowing when to trim, exit, add or initiate when running a portfolio depends on the market and the actions of all the market participants. One must analyse company fundamentals and market patterns and then recognise if the investment has the desired risk-reward given the current known information.

A repeatable process is your compass when navigating the turbulent waters of either process. In cards, if you respond without a clear plan, it will make it harder to succeed. For investors, a strategic mindset incorporates planning, long-term thought and the ability to adjust quickly to changing circumstances. This entails having a well-defined investment thesis and the self-restraint to stick to it when short-term market fluctuations appear to contradict your investment strategy.

Keep a check on emotions

What is clear is that psychological control is vital to success in both cases. In both, one must manage your emotions, avoid impulsive decisions and stick to your process – even during periods of loss. Remaining composed under pressure, be it a rough day with the cards or a stock market meltdown, is incredibly beneficial. Decision-making based on process and experience rather than primal fear or greed will undoubtedly win over time.

Timing

Many investors claim that timing the market is impossible and yet everyone tries to time in different ways. Whether placing an investment in the markets or making a bold decision on a poker hand, one must pay attention to timing. Sometimes, the wisest course of action is to do nothing – to wait for the right opportunity and only act when the chances are more in your favour.

Dealing with losses and drawdowns will set you apart

Losses will inevitably occur across both activities. Discipline will ensure that risk management keeps everyone in the game. The ability to grow from setbacks is what sets the great apart. It is also critical to analyse losses to determine what went wrong and modify your plan accordingly. This ongoing learning and development make growth and long-term success possible in both disciplines – experience counts for so much.

The role of intuition

Poker and investing are both an art and a science. Intuition plays a role in addition to data and analysis. Occasionally, the data only provide a portion of the narrative. Investors and players with experience learn to recognise suspicious activity or offers that seem too good to be true. This "gut feeling", which can be helpful when making decisions, is the product of years of experience or a subconscious synthesis of information that is difficult to measure.

Ultimately, the score is kept by track record, in both cases measured by returns on invested capital. No one can win every hand or trade; the best consistently rise to the top over time. *"In the short run, the market is a voting machine, but in the long run, it is a weighing machine"* Benjamin Graham.

Graham refers to the voting machine reflecting current sentiment, while the weighing machine assesses long-term value. In exuberant markets, particularly those driven by passive investing, fundamentals disconnect and

momentum dominates. This is a difficult environment to make informed decisions; emotional resilience, strategic thinking and effective risk management are paramount to managing portfolios.

The Global Equities team at Liontrust takes an Active Plus approach when managing portfolios, quantitively screening global equities, qualitatively applying change lenses and using our proprietary risk management overlay.

It is really no surprise there are many similarities between card games like Poker and Bridge and investing – strategy, risk management, emotional control and a never-ending quest to win – and it is no surprise that top-notch investors and entrepreneurs make outstanding card game players. Warren Buffett and Bill Gates are renowned Bridge afficionados while David Einhorn (founder of Greenlight Capital) and Chamath Palihapitiya (founder of Social Capital) are great Poker players. The skill sets are highly complimentary and supportive of a key feature of our investment philosophy: there are always two parts to any investment decision – what to buy and when to buy!
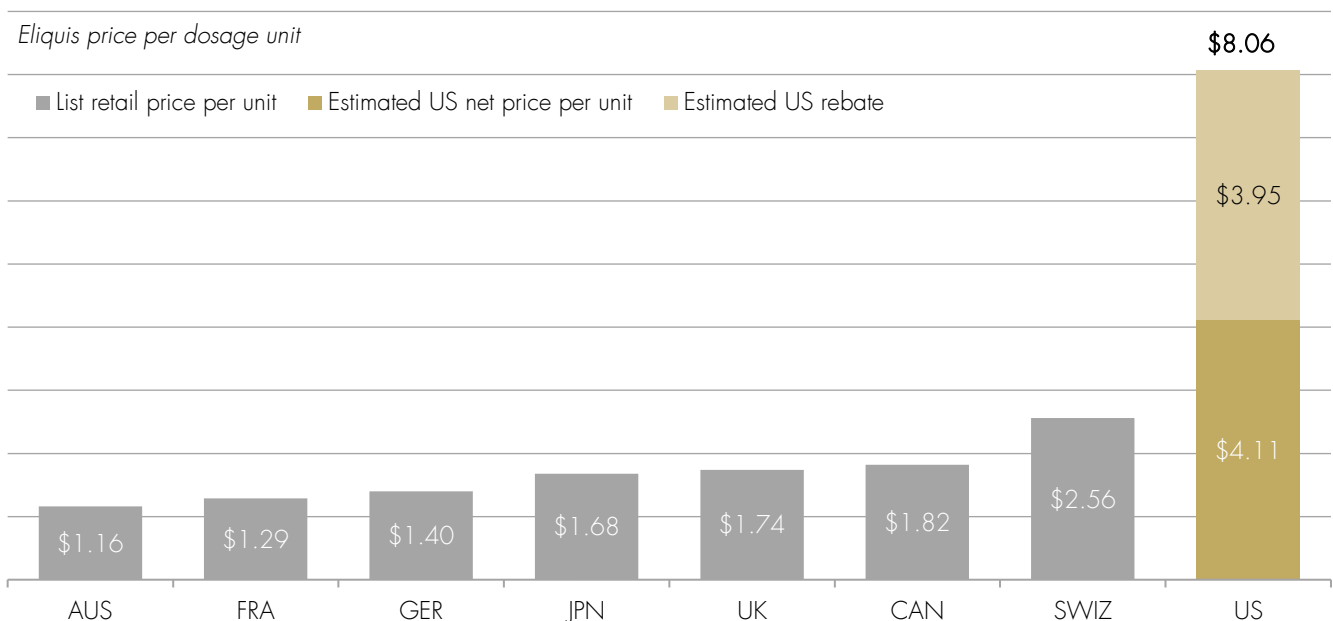
The US prescription drug market is ripe for disruption
KEVIN KRUCZYNSKI

In the US, buying Eliquis, one of the most popular blood thinning medications, costs over three times more than in the next cheapest western world country – Switzerland. It is four times more than in the UK. The pricing system is antiquated and for the US, surprisingly underregulated, leading to a playground of abuse for consumers.
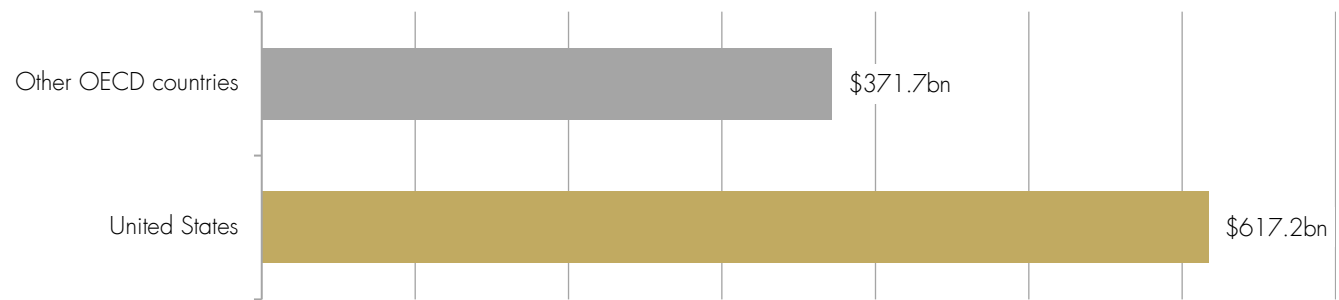
The estimated net price of Eliquis in the US is still higher than the list retail price of the second-highest country, Switzerland

Eliquis price per dosage unit

Legend: ■ List retail price per unit ■ Estimated US net price per unit ■ Estimated US rebate

Country	Price
AUS	$1.16
FRA	$1.29
GER	$1.40
JPN	$1.68
UK	$1.74
CAN	$1.82
SWIZ	$2.56
US	$8.06 (total): $3.95 rebate, $4.11 net, $4.11...

US: $8.06 total — Estimated US rebate $3.95, Estimated US net price per unit $4.11, List retail price per unit $4.11

Source: www.commonwealthfund.org/publications/2024/jan/how-prices-first-10-drugs-medicare-negotiations-compare-internationally
Data: IQVIA, annualized 2021 estimates.

With the US Presidential election looming large, it is no surprise that drug pricing, a long-standing political issue, is back in the spotlight. In 2022, the US spent over $600 billion on prescription drugs, surpassing the combined spending of 33 other leading OECD countries. Research reveals that US drug prices are nearly 2.8 times higher than the average in comparable countries, primarily due to patent protection and the absence of centralised negotiation capabilities. The simple maths on the spend per prescription data shows an even bigger multiplier, over five times.

Prescription drug spend (USD billions)

Other OECD countries	$371.7bn
United States	$617.2bn

Spend per prescription (USD)

Other OECD countries	$4.9
United States	$25.9
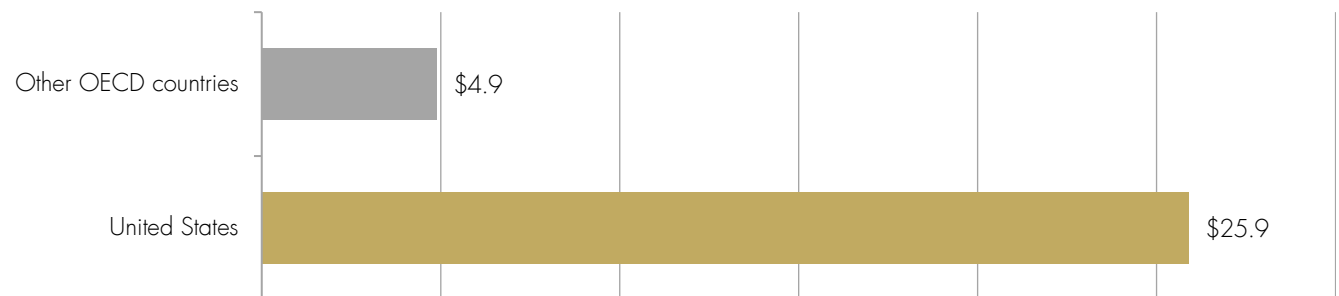
Source: US Department of Health and Human Services. Authors' analysis of 2022 sales and volume data from IQVIA, undated (run date 19 May 2023).

The significant price premium in the US market was bolstered by the Medicare Modernization Act of 2003 that prohibited direct price negotiations between the government and drug companies. Unlike many other countries, the US has no centralised price setting body. Instead, drug companies have benefited from the market becoming fragmented, relying on a complex network of intermediaries like the Pharmacy Benefit Managers, Insurance Companies and Wholesale Distributors, who sit between the manufacturers and the consumers. These intermediaries negotiate rebates and discounts, but the savings do not always reach the end consumer. This dysfunctional system encourages pharmaceutical companies to set high list prices, leaving room for subsequent discounts with no standard pricing – so much so that pharmacies in the same neighbourhoods often quote vastly different prices for the same medications. The table below illustrates this by comparing the prices of a basket of medicines across various pharmacies.

Retailer	Pioglitazone (Actos)	Celecoxib (Celebrex)	Duloxetine (Cymbalta)	Atorvastatin (Lipitor)	Clopidogrel (Plavix)	Total price (USD)
HealthWarehouse.com	$12	$22	$13	$10	$10	$66
Costco	$16	$26	$35	$13	$16	$105
Independents	$19 (10-$493)	$34 ($11-$295)	$31 ($20-$267)	$15 ($8-$197)	$15 ($8-$260)	$107 ($69-$1,351)
Sam's Club	$20	$38	$31	$20	$45	$153
Walmart	$132	$203	$123	$30	$30	$518
Kmart	$160	$185	$120	$35	$35	$535
Grocery Stores	$113 ($10-$349)	$189 ($46-$250)	$170 ($13-$223)	$32 ($11-$71)	$36 ($7-$224)	$565 ($88-$1,117)
Walgreens	$167	$204	$251	$65	$65	$752
Rite Aid	$255	$194	$170	$128	$119	$866
CVS/Target	$270	$187	$195	$135	$141	$928

Source: Consumerrports.org, April 2018.

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This is unsustainable so what can be done to tackle the issue? Several strategies have been proposed. First, allowing more centralised and transparent negotiations between the parties involved. Second, introduce transparency by requiring drug manufacturers to justify their pricing decisions and publish prices in direct-to-consumer advertisements. Third, enhance competition by promoting generic drug alternatives and encouraging competition for new drugs after the brand name products' market protection period. Fourth, align US drug prices with lower prices in other OECD countries. Finally, introduce efforts to reduce patient cost sharing spend with the aim of improving access to affordable medication.

In the run up to the election, we anticipate significant noise and political rhetoric around this issue. However, the impact on companies is likely to be muted due to the formidable army of lobbyists in Washington, D.C. The pharmaceutical industry ranks high in lobbying spending and wields substantial power over government policy. Consequently, proposed reforms often get toned down or blunted. Nevertheless, the Inflation Reduction Act of 2022 granted Medicare, the federal health insurance program, some negotiation powers concerning specific drugs. These changes will be phased in gradually, affecting only a small number of drugs each year, resulting in a modest initial impact, but it is a step in the right direction.

Top 5 lobbying industries in the US – 2023 lobbying spend (USD millions)
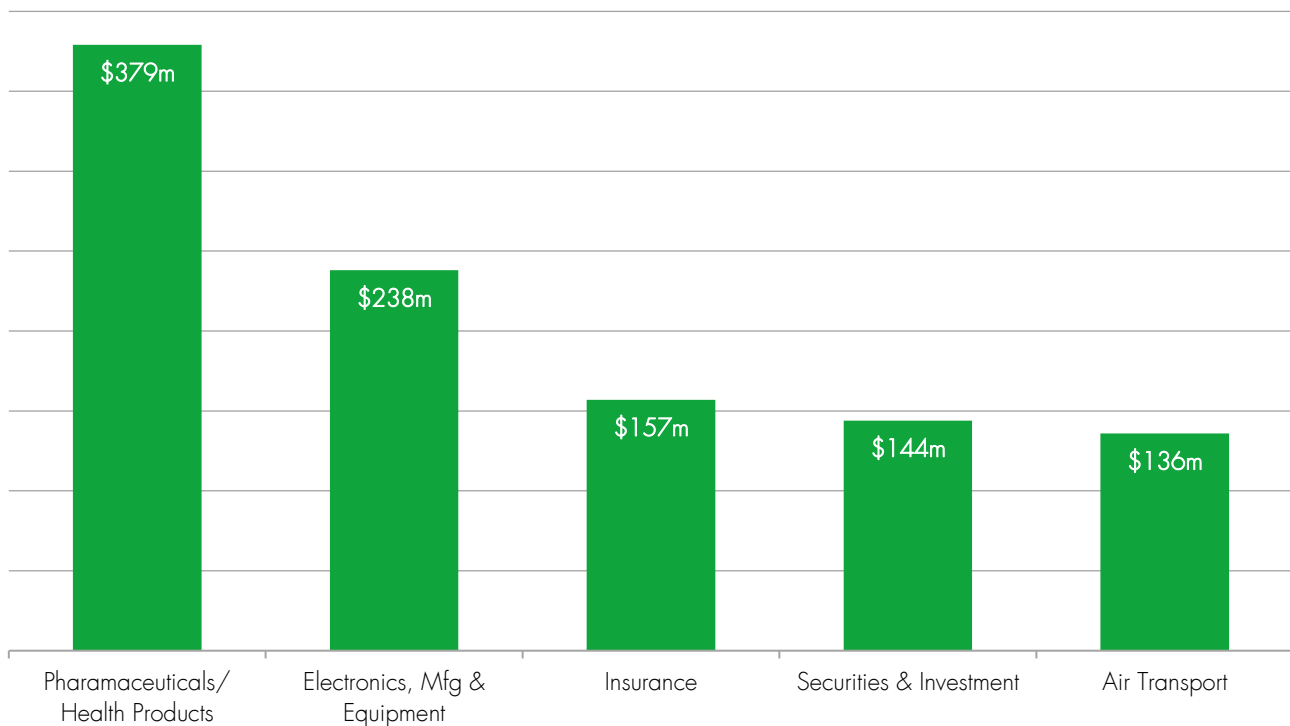
Source: Statista, published 5 July 2024.

In investment terms, complex and irrational systems, as drug pricing is, create an opportunity for disruption and this is no exception. GoodRx is an example of a company that has thrived by helping consumers navigate the complex environment of opaque drug pricing. Its digital healthcare platform processes over 320 billion pricing data points each day and identifies the best deals available, automatically simplifying the complex maze of price structures aimed at boosting big pharma profits at the expense of the consumer.

A GoodRx user can quickly see where the best prices are and secure them accordingly. The opportunity for advanced AI to further level the playing field is immense, one of the many ways it will be used in the future to improve automatically so many of the David and Goliath iniquities.

OUTLOOK

MARK HAWTIN

The Fed commentary surrounding the 50bps cut in September made clear that the economy is strong, yet the rate cut itself might suggest otherwise. So we must believe that the market is going to remain volatile around data points until the path of the economy is clear. CPI prints and jobs data in particular will remain scrutinised in detail. making it hard to predict outright direction into the end of the year.

However, we believe this backdrop is supportive of a broadening out in the market, which should translate into a fertile time for stock/sector/theme pickers. Looking at the winning equities 'baskets' in the third quarter (according to Goldman Sach's designations), the US was led by housing, non-profitable tech, 'power up America' and infrastructure – all lower rate beneficiaries while their AI basket of names turned in a negative quarter. Technology has been sidelined at its broadest level as the next wave of AI opportunity is more carefully scrutinised.

Our base case remains the one which we set out in July: alpha will be generated from a focus on a broadening out of market leadership and less so from betting on the absolute direction of markets. It is time to think beyond the consensus trades of the last 12 months; this should be highly beneficial for stock picking strategies.

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https://www.liontrust.co.uk/benefits-of-investing/guide-financial-words-terms

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