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FROM THE CIO

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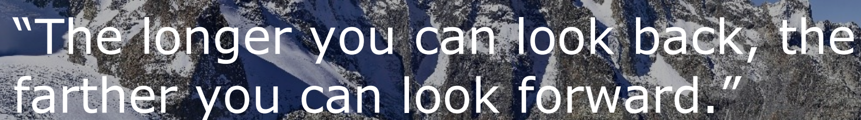
FROM STONES TO SILICON



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The pendulum of "risk on/risk off" that is driven by temporal changes in expectations around the magnitude and timing of interest rate cuts (or lack thereof) continues to drive daily equity prices. The issue is whether core inflation is being tamed or is untamable and if we are in an environment where "higher for longer" is the new normal. The recent returning war intensity between Iran and Israel has lifted oil prices and the corresponding increase in inflation/rates expectations. This has taken the confidence out of equity bull sentiment that inflation and rates are trending lower. Our longer-term view is that the aging populations, technology-driven productivity, and the central bank's tendency to print in periods of extreme economic stress will lead to reduced interest rates, but it does not mean that there won't be periodic upward pressure or rate flare-ups on the longer-term path down. The challenge for investors, and what we tend to focus on, other than guessing this rate direction, is to find those rare companies whose products and services enjoy strong tailwinds of demand such that their core growth is immunized from whether rates rise or fall. To compound this challenge further, it is to not only uncover these companies but to buy them without overpaying, or having the patience to own them for a long time so that what one buys is more important than the timing and price one pays.

The private equity (PE) markets are beginning to see improving conditions around trading/financing activity (especially around large language model Artificial Intelligence platforms) and the "gentle" opening of the IPO market for high-quality technology companies (Redditt IPO), and is indicative of some "green shoots" for exits that are eagerly, if not desperately, awaited for by limited partners (LPs) of the PE industry. Hoarding of dry powder over the last 18 months has interrupted the typical turnover cycle in the PE industry which was a function of the uncertainty of the rate environment and the wide bid-ask spread between sellers and buyers that stalled activity since 2022.

That said, the highest quality companies are transacting whereas capital remains very expensive for lower quality companies. Today, however, great companies can be bought in the secondary markets for meaningful discounts from holders needing to sell for liquidity purposes. We look for and have been active in situations where prices are not reflective of valuation fundamentals. As I have written in the past: price and value are hardly ever the same.

Artificial Intelligence (AI) and its longer-term effect on productivity, labor utilization, corporate earnings, and economic and social policy, is being contemplated in board rooms and kitchen tables around the world. Marc Andreessen's well well-known quote that "software is eating the world" has now taken on a new and even more potent meaning: AI-enabled software is an even greater apex predator and looks like it is poised to consume everything in its path.

Macro and policy-related issues are hotly debated. Equally intelligent players make significant "bets" on opposite sides of this playing field in the game of asset allocation and investment strategy. The introduction of a new technology paradigm provokes intense debates between the optimists/futurists and the fear mentality that is often embraced by the incumbency and legacy paradigm that is threatened by change. In times like this I find myself returning to one of the many insightful quotes from Winston Churchill:

"The longer you can look back the farther you can look forward."

One of the many advantages of having lived in Switzerland has been access to the vast and magnificent natural landscapes that the Swiss people have so wonderfully curated. The magnificent mountains constantly remind you that we are merely a continuation of many generations that preceded us. I often go into the mountains on weekends to get grounded in that longer-term perspective. In the mountains, one is almost forced to look far back into history.

One of my favorite regions is the Engadin Valley which is in the south-eastern tip of Switzerland. On a recent weekend trip there to get submersed and grounded into a nature-rich perspective, I also started reading a book on the ancient human history of the region which started at the end of the Ice Age about 11,700 years ago when the melting ice opened up a valley that was previously inhospitable. The book's focus was on how tools, innovations, plagues, population growth, and climate changes in this somewhat isolated valley, continuously changed social hierarchies and the prosperity of the valley. Notably, it was quite insightful how "tool" developments and the groups that controlled those innovations, transformed that particular ecosystem over the centuries.

Melting ice opened up valleys and streams, revealing sharp stones that were collected, and after being modified and sharpened further were used as "tools to hunt". Similarly, "tools to dig" were created to cultivate life, which led to agriculture, domestication of animals, and ultimately permanent settlement of the region. Fertility had arrived. Eventually, the discovery of a new substance (copper) led to the Copper Age and tools became even more efficacious. The progression of material superiority from stone to copper, copper to bronze, and then bronze to iron each marked "technological pivots" driven by material and design superiority and subsequently sparked the transformation of the local social structures. The greatest winners possessed and used the new technology. The same story applies to the rest of the world with the creation of machines made from metals that led to new devices/applications (steam engine, etc.) roads, and a whole range of additional "machines" powered by steam and combustion engines into what became the industrial revolution or automation wave 1.0.

The study of these technology "Ages" (Stone to Silicon) helped me contextualize the waves of economic progress and how ultimately each initial step of innovation and subsequent incremental steps catalyzed changes across society and "industries". Now, as we commence the start of the AI-enabled computing age, the new Large Language Models (aka new "digging tools" and automation 3.0) being applied to larger data pools (fields), it is clear that we are at the cusp of some significant alteration to the established hierarchies of power in both the corporate worlds but also public institutions, too. With each technological pivot in the past marked from one of these "Ages" to another, the duration of the incumbent technology dominance got shorter, and the adoption of new technology got faster. With each "advancement", the rate of change became compressed in time. Tribes or regional relative powers were constantly battling, negotiating and towns and villages were constantly reshaped. New regional alliances, kingdoms and industries/companies were born. Others died or were taken over and incumbents not embracing the new technology, fought a losing battle to sustain relevance.

More modern analysis reveals how dynamic corporate and industry domination has been over the last four decades and shows that the same triggers (technology innovations) that catalyzed resets in older times are essentially the same catalysts that reset them in modern times. With very few exceptions, leadership, or dominance amongst companies in the USA (or world for that matter), is in constant flux. Companies that were the leaders in the 1950's and 1960's were predominantly consumer goods companies driven by the post-war baby boom. Names likes GE, McDonalds, Coca-Cola, Pfizer, etc. Interestingly, it is not surprising that Mr. Buffet likes these companies as they were his generation's peer leaders. As the cost of capital became cheaper for these business models lots of conglomerates were assembled. These were then known as the Nifty 50 stocks - the Mag-7 precursors. They ultimately became "must-owns" by everyone; prices/valuations got inflated in the late 1960's but then these stocks lost their "crown of leadership" during the inflationary period of the 1970's when energy stocks and commodity stocks took over the leadership roles. Then in the 1980's it was the emergence of technology sectors where IBM led the pack and lots of new companies were born that leveraged computing power. The modern-day LBO came into its own in the 1980's as the creation of the modern High Yield market enabled corporate raiders to buy and bust up these old conglomerates from the 1960's. The inflationary period of the 1970's inflated the real assets on their balance sheets and deflated the financial value of the stocks, creating a natural arbitrage enabling the raiders to buy the whole at a discount and liquidate the parts to pay down the debt.

Further advances of technology leaders continued in the late 1990s with the technology, media and telecom ("TMT") sectors dominating with the likes of Cisco Systems, Lucent Technologies, Dell Computers, and Microsoft commanding top positions. The modern internet infrastructure build-out created mega fortunes for the builders and those who built their "shops" along the new traffic patterns, just like the same fortunes accrued to the railroad barons and real estate developers along those rails 100 years earlier.

New power will accrue to those that build applications upon the new AI (GPT4 etc.) infrastructure just like it occurred to those who were positioned on the right side of the valley to transverse the foot/mule paths through the Engadin Valley ages ago or to those who captured and/or delivered value along the rail infrastructure in the 1870's or internet infrastructure in the 1990's.

Innovation adoption leads to rotation in leadership and market share. That is to be expected, and well understood. One of the performance advantages of the S&P 500 is that it is continuously rebalanced and led by new companies. With transformational technology that has the scope and total addressable market ("TAM") that AI has, it is clear that the aggressive adopters will have enormous potential and that the future dominant companies in 20-30 years will not be the same as those leading today.

Today's tech-heavy Mag-7 are on average about 33 years old and were unprofitable for around 8-13 years since their founding. Along that pathway since inception, they each consumed considerable capital to develop their products and market share. Today, these companies have a combined market capitalization of approximately $12 trillion which is over 30% of the entire market capitalization of the S&P 500 of $43 trillion. Pareto's principle applies. The common denominator is persistence. To me, it is clear that the leaders over the next 10-20 years will be different from those leading today especially given that we now have a technological innovation that is highly likely to disrupt incumbents. The issue is how to build an investment strategy to not only gain optionality to spot and identify these emerging winners but also to protect one's capital from erosion by staying invested in slower adopters that lose relevance to the new disrupters.

How we think about Portfolio Construction and Selection:

Digital natives = AI natives:

Investing themes within the global knowledge economy and embracing innovation have been a constant for pretty much my entire career and this experience has greatly defined our investment philosophy at Alpha Leonis Partners ("ALP"). Heretofore at ALP, we have predominantly focused on companies with innovative tech-adoption that has translated into proven or near-term cash flow potential. Many of these "digital champions" are in our opinion positioned best to also evolve into "AI champions" over the near-term, but we also believe that tomorrow's leaders are likely in the wombs of innovative formation today. Early stage or VC investing is especially exposed to rates because of the duration. Rate increases are like a fire in the forest; small seedlings get singed, saplings get scarred, dead wood gets burned fast and only the biggest trees with the strongest bark and deepest roots (moats) make it. But at the end of the fire, the forest floor is clear, sunlight and water can reach the new batch of seedlings, younger trees can thrive and the process of renewal begins.

There are a lot of ways to invest in these dynamic evolving markets and while it is popular to label strategies as either "value or growth" we view companies on the spectrum of cash flow duration. Long-term higher-growth cash flow models are often labeled as "growth" and shorter duration predictable cash flow companies are labeled as "value". We seek to build portfolios for our clients that are diversified by style (pure growth and value with a growth catalyst) and do so by being cognizant to match the asset duration with the liability duration of that particular investor. Shorter-duration cash flows are more capable of supporting leverage and often are more "boring", so it is common to leverage them to lift equity rates of return whereas longer-duration models (venture capital or growth equity) require much more equity-styled patient capital.

Growth mindset versus the value mindset: One of the reasons why there is often philosophical tension at points of technological inflection is because of the embedded difference in mindsets between futurists (the challengers) versus the incumbents. This is also a factor that is a continuous aspect of the spectrum of human psychology. I think about this a lot as we encounter a full range of personalities that can be successful in investing or running companies and there is not one right- or one wrong perspective. I put together the below table to summarize my perspective and experience in this domain.

Value Mindset	Factors	Growth Mindset
Fear-based	Mentality	Faith-based
Incumbent being disrupted	Market Position	Being the disrupter
Pessimistic-based	Weakness	Optimistic-based
Larger companies surrounded by committees designed to protect incumbency and market share	Corporate Culture	Smaller companies' owner occupied/managed with no or few committees
None or incrementalism	Innovation Style	Big game changers
You see downside and what can go wrong	Confirmation Bias	You see upside and what can go right

One of the aspects we emphasize in our investment philosophy is that entrepreneurial persistence and a growth-tilted mindset have been a proven combination for success over the centuries. Embracing the new and leaving one's comfort zone is an unnatural act for most humans. It takes courage and it takes energy, but it is required to overcome the conformation bias that is innate in human psychology. It is always easier to remain in the stasis of the status quo and it is especially difficult to change for those who have established power and plenty of resources. New is embraced by the

challengers, those who are not resting on any laurels or in established positions. The entrepreneurial spirit of this quest is embedded in the hunger that drives immigration and a desire for improvement and it is almost always more actively embraced by entrepreneurs in private company settings.

Embracing this defines our investment philosophy and it is rooted in centuries of human progress. Ignoring technological innovations is tantamount to putting one's head in the sand and exposes one's future to losing relevance to the new AI-based Apex predator.

As David Goggin's said: "Stay Relentless".

Respectfully,
David B. Pinkerton

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