

“ *Artificial intelligence is not a substitute for human intelligence; it is a tool to amplify human creativity and ingenuity.*

–Fei-Fei Li, Stanford Institute for Human-Centered Artificial Intelligence and IT ”



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## The Lamplighters – Shining Some Light on AI

Dear Client,

After a strong year in 2023, we are pleased to have continued the positive momentum through the first quarter of this year. In conversations with clients, the two questions that are most often asked are: “Should we invest in AI (artificial intelligence)?”, and “With markets at all-time highs, should I be selling equities?”

Over the course of this letter, we intend to discuss both of these.

### AI

There is no question that artificial intelligence will significantly impact our world, probably both in good ways and bad. Imagine being able to consult your doctor, who would enter your symptoms into an AI engine and generate a diagnosis within seconds. Of course, we will always need the judgment of an experienced physician, but AI

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would make our medical system far more efficient, leading to better patient outcomes at lower cost.

AI is already being used by many industries. Insurance companies are using AI models to better evaluate and price risk. Banks are using these models to evaluate the creditworthiness of borrowers, and consumer companies are using this technology to better predict purchasing behaviour, and therefore be more efficient at managing their inventories.

At the same time, we are already witnessing some of the potential risks of AI. Social media and other web-based media are filtering the news that we read, based on our past choices. The same is true of the ads that we see and the information that is sent to us.

These are but a few (of countless) examples of the impact that AI will have on all of us. This is a very powerful tool that has become a hot topic among thought leaders, educators, politicians, philosophers, and investors. We are reading daily about AI startups, and the large amount of investment being poured into this area. This has led to many questions about whether we should have exposure to this emergent technology.

The answer: we are already invested in a number of companies that are leaders in AI.

For example, Microsoft invested in OpenAI (creator of ChatGPT) before most of us had ever heard of it, and Microsoft has already incorporated AI into a number of its products, which should generate significant revenues starting this year.

Some of the other largest investors in AI are Meta, Google (Alphabet) and Amazon, all of which make up part of our LSWM global value strategy. In fact, Google is considering charging for AI-powered searches, in what would be a monumental change to its business model, and would mark the first time any of its core offerings would be placed behind a paywall. Taiwan Semiconductor (TSMC), also found in our global strategy, manufactures the chips required to drive this growing engine. More on TSMC, below.

The share prices of each of these companies have benefited from the aura of AI. While we continue to see good value here, we also own several less exciting businesses that remain global leaders in their field, and which continue to generate sustainable (and growing) dividends and revenue growth.



## With markets at all-time highs, where do we go from here?

Markets are at all-time highs, largely driven by the technology and communication sectors, as it has become apparent that AI should boost the long-term outlook for many of these businesses. While it is true that these companies are not as cheap today as when we first started investing in them, their valuations have been bolstered by accelerated growth of earnings and free cash flow. There are very few businesses with over \$100 billion of revenues, high profit margins and no debt, whose revenues are growing at over 10% per year.

Simply put, these businesses are earning their valuation and our estimate of fair value is well above today's prices. At

the other end of the spectrum, we are just as excited about the balance of our portfolio - those world-class companies with steady earnings and dividend growth. We understand that these securities will not be the topics of conversation at dinner parties, but they have great franchises with long-term track records, and are trading at compelling valuations.

Much has been written about the prospect of lower interest rates this year. However, whether or not there are rate cuts in the near term, we own a well-diversified group of companies that should deliver value over the next many years, and whose prospects will not be materially impacted by a change in rates.

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## Starbucks

Founded in Seattle in 1971, Starbucks is the preeminent global coffeehouse chain, with over 35,000 stores in more than 80 countries. Through a strategic relationship with Nestle, the company also licenses its own branded packaged goods, which adds about 5% to group sales and more than double that in profits. The company's success is rooted in its ability to offer high-quality coffee, other beverages, and food items, in a welcoming and comfortable store environment that resonates with consumers. Starbucks has positioned itself as a premium brand, which has resulted in high margins and strong customer loyalty.

The company has also demonstrated an ability to adapt to changing consumer preferences over time, as evidenced by its expanding menu options, including healthier choices and plant-

based alternatives. The Starbucks rewards program and mobile app have been particularly successful, boasting over 75 million members, accounting for over half of total transactions, with these participants being five times more likely to visit a Starbucks every day. While the pandemic posed significant challenges, the company showed remarkable resilience and continued to generate free cash flow. Their growth strategy is multifaceted, focusing on expanding its global footprint, enhancing digital and mobile capabilities, and driving innovation in the product lineup. As a result, we anticipate continued strong revenue growth, while maintaining significant free cash flow. The excess cash has been used for share buybacks and dividends, and the company is well-positioned for the future.



## Taiwan Semiconductor Manufacturing Company (TSMC)

Founded in 1987, TSMC was the world's first dedicated semiconductor foundry business (i.e. manufacturing chips for others) and has long been the leading company in its field. As a critical supplier to leading tech companies, TSMC's advanced manufacturing capabilities are essential for producing the most sophisticated semiconductor chips, which are used in a wide range of products, from smartphones and computers to automotive electronics and data centers. The barriers to entry are substantial, with a new fabrication facility costing \$10-20 billion and taking 3-4 years to build. The technological barriers are arguably even higher. With a relentless focus on research and development, TSMC is in the enviable position today of being effectively the sole provider of meaningful capacity for leading-edge chip manufacturing. This includes using miniaturization processes that can scale down to a mere 2 nanometers (nm) wide. To put that into context, 2nm is the width of a strand of DNA.

The company's business model is also a key strength. By operating as a pure-play foundry, TSMC can serve a diverse set of customers without

competing with them, fostering strong partnerships and a stable customer base. This has led to long-term relationships with industry giants such as Apple, Qualcomm, and Nvidia. Despite the inevitable cyclicity of this sector, over the past quarter of a century, TSMC has delivered strong organic growth in sales and profits. The company has high operating margins and boasts a net-cash balance sheet, allowing for significant continued investments in capacity expansion and technological advancements.

TSMC is also benefiting from the recent U.S. government policy to increase chip manufacturing in the U.S. In return for building a large new plant in Arizona, the company was recently awarded \$6.6 billion as part of this policy, and further capacity is expected to be added in the U.S.

Looking ahead, the demand for advanced semiconductor chips is only expected to grow, driven by all the longstanding trends as well as more recent ones such as generative AI. TSMC's leading position in the industry, coupled with its strategic investments in capacity and technology, positions it well to capitalize on these opportunities.

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## Walt Disney

Walt Disney does not need much of an introduction. It is a diversified global entertainment giant, with operations spanning theme parks, cruise ships, media networks, movie studios, and streaming services. The company's iconic brands, beloved characters, and vast content library have cemented its position as a leader in the entertainment industry with a content portfolio that is arguably unrivaled. Its portfolio includes Marvel, Lucasfilm (Star Wars and Indiana Jones), 21st Century Fox, Pixar, Touchstone, ABC, and National Geographic, along with franchises such as The Muppets, Pirates of the Caribbean, Chronicles of Narnia and Winnie the Pooh.

Last year, Experiences (theme parks, cruise line) accounted for 36% of revenues, while generating 70% of operating income. The Entertainment

division accounted for 45% of revenues (movies, cable channels, the streaming activities of Disney+ and Hulu, and content), but only 11% of profits, with the balance coming from Sports (including 80%-owned ESPN).

While not without its challenges, Disney's foray into streaming with Disney+ has been successful in terms of the number of subscribers, but disappointing thus far in terms of profitability, as the losses from streaming have been significant. However, this division should reach break-even by the end of this year, which, when added to recent cost-cutting, should result in much-improved results going forward. Disney's great content, coupled with its recent restructuring and investment, should result in renewed profit growth over the next few years.

## High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: [High Yield Quarterly](#).

## Final Thoughts

On the night of April 24, 1907, New York's lamplighters (their job was lighting Manhattan's 25,000 gaslights) went on strike and the streets of Manhattan went dark. The reason for the strike was that their jobs were to be replaced by Thomas Edison's invention - the light bulb. Society benefited from the new technology, but the lamplighters lost their jobs.

Automation has caused significant structural change in the workforce, and this trend will continue. However, despite the loss of manufacturing jobs, unemployment is at historic lows.

The example of the lamplighters relates to AI. Every time there are technological breakthroughs that benefit society as a whole, there will be resistance to change, with job growth in some areas and job losses in others. However, technological advancement is inevitable, and we have every reason to be

optimistic that the integration of AI will lead to a higher standard of living, and that disruption from these new advances will be outweighed by the benefits.

The current state of the stock markets is reflected in our portfolios. Our performance is due, in large part, to our technology stocks, which continue to offer attractive value, but there are many other excellent companies that have been ignored at present and that offer excellent value as well.

Sincerely,



Lorne Steinberg  
President

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