

Re: The AI Tsunami

*Warner
Your Team!*

2025 was a tumultuous year marked by tariff shocks in April, geopolitical conflicts throughout the year, and of course, the surge of Artificial Intelligence (AI) development which propelled AI-related technology stocks to record high prices prompting debate as to whether or not this is another speculative stock bubble. At the height of the tariff shock on April 9th, the S&P 500 was down by 15% for the year and the AI-related Magnificent 7 stocks were down by more than 25%. As the year progressed, and as many of the fears subsided, the stock market recovered and surged to record high levels with annual gains for the year of 17.9% for the S&P 500 and 23% for the Magnificent 7. A surprisingly strong year for the markets given all the turmoil and uncertainty.

Time Magazine named the architects of AI as their 2025 Person of the Year to recognize individuals who helped design and build Artificial Intelligence. In the cover image to the right, you will see the CEOs of Meta (aka Facebook), Advanced Micro Devices (AMD), Tesla, NVIDIA, OpenAI, Google DeepMind, Anthropic and World Labs sitting on a steel beam above New York City which harkens back to the iconic photo taken in 1932 of ironworkers sitting on a steel beam eating lunch during the construction of the 70-story Rockefeller Center skyscraper.

It is estimated that businesses spent more than \$600 billion in 2025 on AI development which vastly surpassed the \$250 billion spent in 2024. Total global spending on AI is projected to reach \$2 trillion in 2026 when counting development, infrastructure, and end users of AI solutions. Most of the capital expenditures in 2025 were made by the Magnificent 7 companies, but close to one-third of the \$600 billion expended was attributed to startup companies funded by private investment. In addition to the eight companies named by Time Magazine, other familiar companies are funneling massive sums into AI infrastructure and cloud services, including Amazon, Microsoft, Alibaba (China), Oracle, Apple, IBM, and Tencent (China). Including the aforementioned companies, there are more than 125 companies in the U.S. with significant involvement in AI, and another 90 companies outside of the U.S. More than 40% of the market capitalization of the U.S. stock market is linked to AI, and about 33% of the global stock market. With all of this investment, and even more to come, some are characterizing this as another speculative stock market bubble with parallels to the Dot-Com Bubble of the late 90s. While there are clearly



parallels, the good news for investors today is that much of the capital spending on AI is being done by established and highly profitable mega-cap companies which derive revenue from diversified sources unlike many of the Dot-Com stocks which had no revenue or profits to begin with. Furthermore, the Dot-Com bubble was inflated to a large extent by the hype and promise of a new economy propelled by the internet long before the internet's infrastructure was sufficiently developed for mass consumer consumption. For example, it took Amazon about 9 years to become profitable following its founding in 1994. At the height of the Dot-Com bubble in March of 2000, Amazon was trading for \$3.60 per share, but by the time the bubble deflated in late 2002, its price had fallen to less than 35 cents per share (a whopping loss of more than 90%!). The NASDAQ stock index (the primary exchange for Dot-Com stocks) lost more than 70% of its value between March 2000 and September 2002, and it took more than 15 years to fully recover (it took Amazon more than 7 years to recover from its low point). Once the bubble burst, many of the hundreds of poorly capitalized Dot-Com stocks

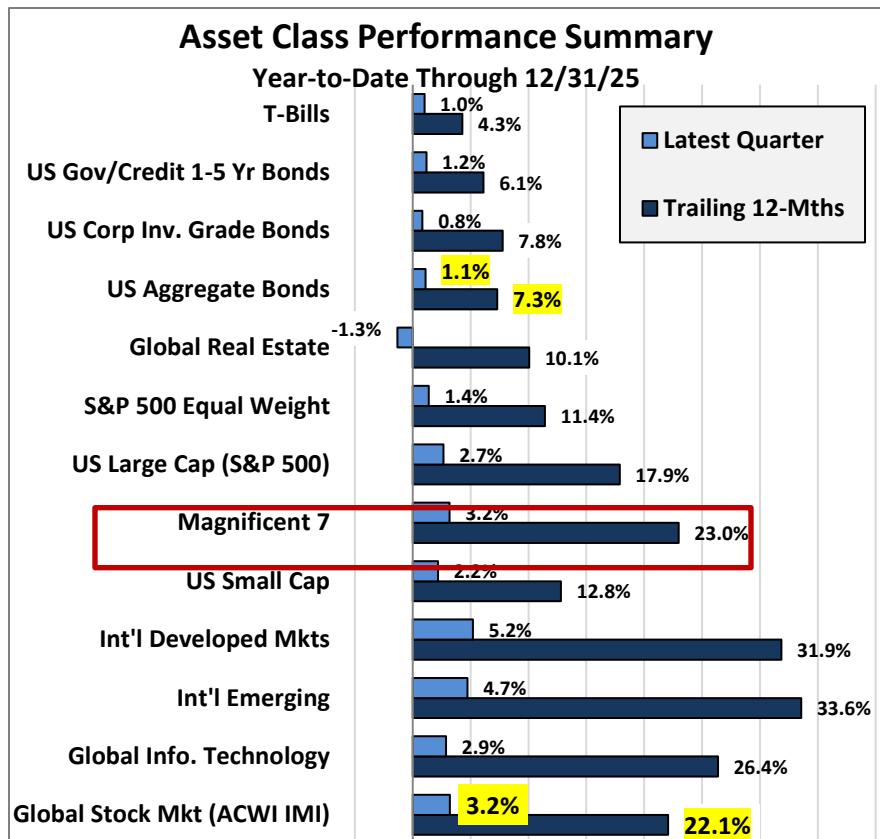
went bust, but for those which were well-capitalized with solid business models such as Amazon, eBay, Google, and even NVIDIA, the rewards have been enormous. Looking forward, it might still take many years for AI companies to realize profitability on their investment, and we might see a similar meltdown in AI-related stock prices before earnings begin to fully support their prices. One of the lessons learned from the Dot-Com crash was that other areas of the stock market, particularly Small and Large Cap Value stocks, performed relatively well during the period between March 2000 and September 2002 given that their valuations (e.g., P/E Ratios) were not unsustainably inflated. Another lesson was that balanced portfolios which included high-quality bonds combined with globally diversified stocks successfully protected investors' portfolios. For example, while the NASDAQ fell by more than 70% during the 2000-02 Dot-Com crash, a highly-diversified 40% bond and 60% stock portfolio was down by less than 5%.

Before digging into further thoughts about Artificial Intelligence and portfolio diversification during this arguably "bubbly" time for the stock market, we will report on the remarkable performance for the various asset classes for 2025.

Asset Class Performance

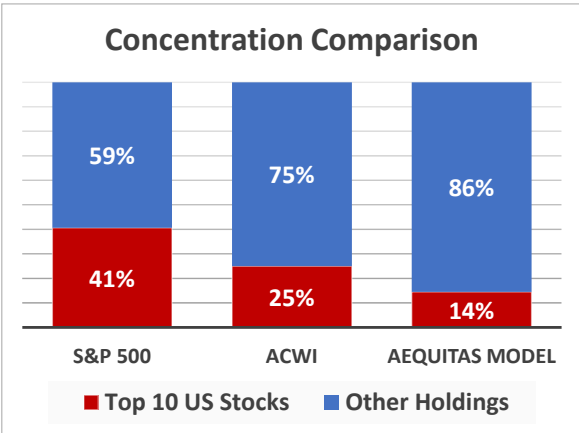
For the calendar year, every major asset class and sector included in the Asset Class Performance Summary at the bottom left produced extraordinary returns. The U.S. Aggregate Bond Index was up by 7.3% while the Global Stock Market advanced by 22.1% (in contrast, looking forward over the next 10 years, we expect bonds to generate an average annual return of 4.6% and stocks, as measured by a globally diversified portfolio, are expected to generate an average annual return of 6.1% based upon current valuations). Surprisingly, AI-related stocks were not the biggest story for investors in 2025 as International Developed and Emerging Markets stocks posted the strongest performance with gains of close to 31.9% and 34% respectively. Foreign stocks benefited from a weakening U.S. dollar with about one-third of their gains being attributable to their appreciating currencies relative to the U.S. dollar. Next in line were Global Information Technology stocks (+26.4%) and the largely overlapping Magnificent 7 stocks (+23%). U.S. Large Cap stocks gained 17.9% followed by U.S. Small Caps (+12.8%), the S&P 500 Equal Weight Index (+11.4%), and Global Real Estate (+10.1%). Within Fixed Assets, U.S. T-Bills gained 4.3%, U.S. Gov't/Credit 1-5 Yr Bonds gained 6.1%, and U.S. Corporate Investment Grade Bonds gained 7.8%.

For the latest quarter, every asset class and sector in the Performance Summary posted a positive return except for Global Real Estate. The U.S. Aggregate Bond Index was up by 1.1% while the Global Stock Market gained 3.2%. International Stocks continued their outperformance by a slight margin. The range of returns within the stock asset classes was between a low of -1.3% (Global Real Estate) to a high of 5.2% (Int'l Developed Markets).



Stock Market Valuations

Whether we are in another stock market bubble driven by AI stocks or not, the most prudent way to avoid being overly impacted by a potential bursting of the bubble is to establish an appropriate mix of high-quality bonds and diversified stocks, and to underweight those areas of the stock market which appear to be over-valued. As the stock market has become overly concentrated in the largest ten stocks, including the Magnificent 7, we have advised our clients to significantly underweight the Top 10 stocks and to overweight areas of the Global Stock Market which appear to be more attractively valued with higher expected future returns. The Concentration Comparison graph on the next page indicates how our model portfolio is diversified in such a manner. The bar to the left on the graph represents how the S&P 500 Index is currently weighted with 41% of its market capitalization invested in the Top 10 U.S. stocks which represents a record



high level of concentration. The middle bar indicates what portion of the MSCI All Country World Index is weighted toward those same Top 10 U.S. stocks. The bar on the right is our current model's allocation to the Top 10 which is 14%, meaning that 86% of our model portfolio is invested in stocks other than the Top 10. Thus, we do not recommend avoiding the Top 10 U.S. stocks

alignment with our model has an expected average annual return of 6.1%. Balanced Portfolios of various asset mixes have expected returns of between 5.5% and 6%. The bottom line is that we believe it is prudent to underweight the largest 10 U.S. stocks, including the Magnificent 7, and to overweight U.S. Small and Mid-Cap stocks with a tilt toward Value stocks, and to include International Developed and Emerging Markets stocks in the overall asset mix.

The Promise of AI

While the future performance of AI-related stocks might end up disappointing investors at least in the near term, we believe that the advent of AI will prove to be a transformative technological shift comparable in scale to the development of telecommunications of the 1990s and the development of railroads in the nineteenth century. Each of these two transformations required intensive capital to build and it took many years to provide a positive return on the invested capital expenditures. Of course, AI must first deliver on its promise to transform how we work and interact in order to deliver positive returns for AI developers. In the four boxes below, we have listed how AI technologies might improve Healthcare, Society, Daily Life, as well as having a Broader Impact. It is not difficult to imagine how AI might improve these four areas given that we are already seeing some of the advancements. And in the case of our own company, Aequitas Investment Advisors, we are continuing to integrate several AI technologies into our workflows which we believe will enable us to enhance our service offerings, create efficiencies, and provide us with more time to work directly with our clients on their unique goals and objectives.

entirely, rather, we recommend significantly underweighting them in favor of stocks with more attractive valuations and higher expected future returns. As mentioned previously, a similar diversification strategy worked very well for our clients following the Dot-Com crash between March 2000 and September 2002.

The table below indicates the latest 10-Year Future Rate of Return Forecasts for many of the major asset classes as well as various mixes of bonds and stocks. The estimates are calculated by Research Affiliates and are founded upon the Nobel Prize winning research of Robert Shiller who devised a very useful method of forecasting future long-term stock market returns. The estimates for Diversified

| | 10 Year "Expected" Return | Risk Level (Standard Deviation) |
|----------------------------|---------------------------|---------------------------------|
| Equities | | |
| US Small Cap Value | 8.4% | 19.1% |
| Non-US Developed Markets | 7.7% | 19.4% |
| Emerging Markets | 7.5% | 16.0% |
| Global Equities Mix | 6.1% | 15.8% |
| US Small Cap Growth | 5.7% | 22.2% |
| US Large Cap Value | 4.2% | 15.0% |
| US Large Cap (S&P 500) | 3.1% | 15.0% |
| US Large Cap Growth | 1.4% | 17.0% |
| Fixed Assets | | |
| Diversified Bonds | 4.6% | 2.6% |
| Cash (Money Market Funds) | 3.5% | 0.7% |
| Balanced Portfolios | | |
| 20% Fixed - 80% Equities | 6.0% | 12.8% |
| 40% Fixed - 60% Equities | 5.8% | 9.8% |
| 50% Fixed - 50% Equities | 5.7% | 8.4% |
| 60% Fixed - 40% Equities | 5.5% | 6.9% |
| Inflation | 2.6% | NA |

Bonds and Inflation reflect various economic assumptions, including the Fed's monetary policy goals. The Magnificent 7 stocks are contained within the overlapping US Large Cap and US Large Cap Growth sections of the market. The expected return, therefore, for the Magnificent 7 would be between 1.4% and 3.4% annually for the next 10 years (a paltry return in contrast to their 20%+ average annual return as a group over the past 10 years). At the opposite side of the size spectrum are U.S. Small Cap Value stocks which have the highest expected average annual return of 8.4%. A globally diversified portfolio of stocks in

Healthcare

- Early Diagnosis of diseases
- Personalized Care: Monitors vitals and activity via wearables, communicates with physician
- Administrative Efficiency: Automates paperwork, freeing physicians to focus on patients

Daily Life

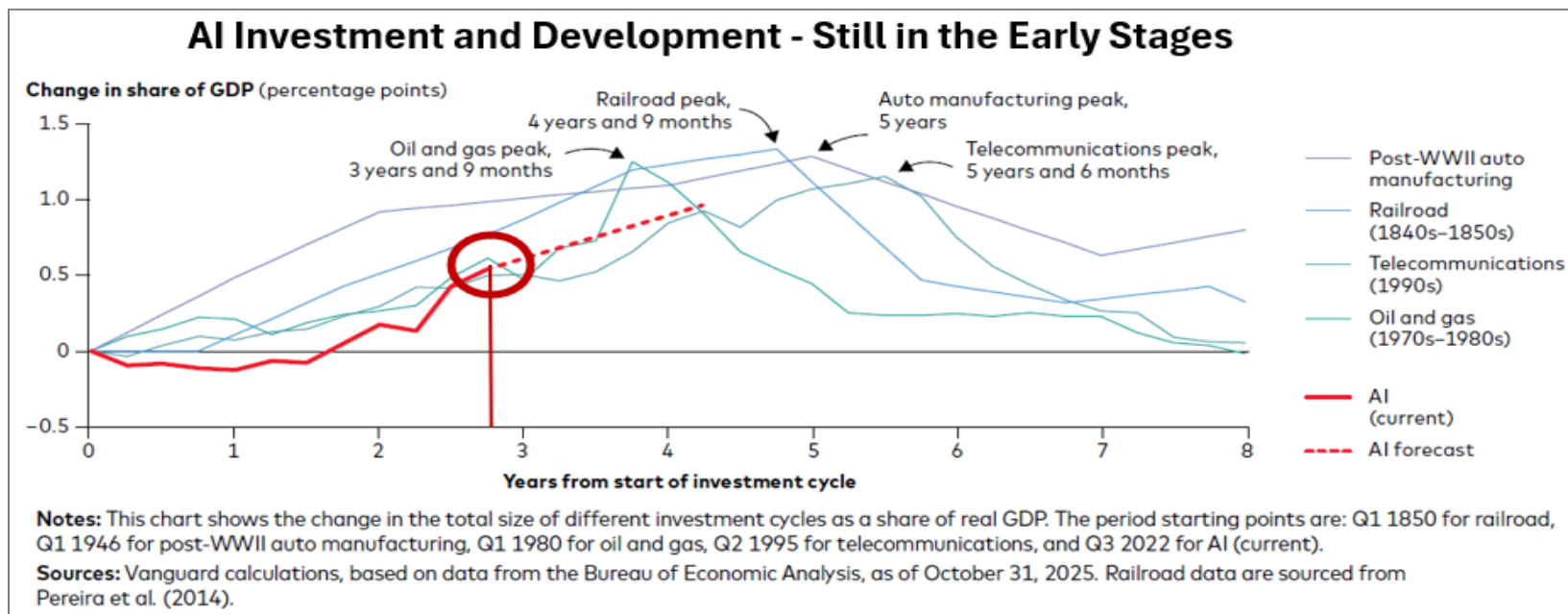
- Smart Assistants: Manage personal schedules, answer questions and control home smart devices
- Personalization for Google Searches
- Enhanced Communication, real-time language translation
- Automation: handles repetitive tasks

Society

- Agriculture: optimize crop yields and reduce waste
- Transportation: Power autonomous vehicles and trucks and optimize traffic routes
- Security: Advanced fraud detection and data protection
- Creativity: Assists in generating content, music and special effects
- Aging in Place: With personal robots and autonomous transportation, would allow more options for remaining in one's home

Broader Impact

- Problem Solving: able to analyze huge datasets to address major challenges such extreme weather forecasting, predictive risk modeling and worker safety
- Accessibility: Potential to make life easier for people with disabilities
- 24/7 Availability: Offers continuous support services



AI Still in the Early Stages of Development

The line chart above compares the impact on the overall economy (measured by contribution to GDP) of AI investment and development up to this point (red line and the red circle) to other major transformative investment cycles over the past 175 years, including the developments of the Railroad, post-WWII automobile manufacturing, Oil and Gas extraction, and Telecommunications. Each of these transformations took between 4 and 6 years to reach their peak impact on the economy. In comparison, AI is less than 3 years into its development path with possibly another 2 to 3 years to go. This implies a lot more capital will be flowing into AI's development and there will be winners and losers along the way. The closest comparison might be the Telecommunications transformation of the 1990s which ushered in a seismic shift from analog to digital technology, as well as the advancement of the internet and cellular communications. The early winners in that cycle ended up losing their dominance or even disappeared (e.g., Lucent, WorldCom, AOL, Nokia, BlackBerry, and Motorola), while other companies survived and prospered. While there is a very low probability that the current Magnificent 7 companies dominating the current AI space will disappear as many did during the Telecommunications transformation, it may nonetheless take many years for AI companies to realize profits on their capital investments. And like many early investors in the Telecommunications cycle, if profits fail to materialize as quickly as they analysts are forecasting, AI-related technology stock prices might tumble before ultimately providing favorable returns for the survivors.

Hedge Funds Turn Chaos into Cash for Best Gains in 16 Years

In closing, and with further reflection upon the favorable returns in 2025, an interesting article appeared on the Bloomberg website which noted that the \$5 trillion dollar hedge fund industry posted an average gain for their investors of 12.6% in 2025, their best return since 2009. According to the article, "The banner year was made possible by markets that swung with artificial intelligence buzz, geopolitical shocks and interest rate uncertainty, all of which combined to create rich trading opportunities for strategies designed to thrive amid volatility." Certainly, the hedge fund managers made lots of money given their typical average annual fee of 2%, plus a 20% performance fee on profits, and with such egregious fees, it is no wonder a return of 12.6% was noteworthy. Perhaps even more noteworthy was the performance of representative globally balanced 40% bond and 60% stock portfolios at Aequitas which posted gains of close to 15% for the year. We have long argued that hedge funds on average end up merely generating high fees for their managers while providing mediocre returns, or worse, for their investors. At Aequitas, we believe that a low fee structure combined with our fiduciary pledge to serve our clients' best interests can generate favorable returns for our clients while also enabling us to maintain a successful and sustainable business model that is now entering its 36th year! *We deeply appreciate your trust and confidence over these many years!*

