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INVESTMENT MANAGEMENT

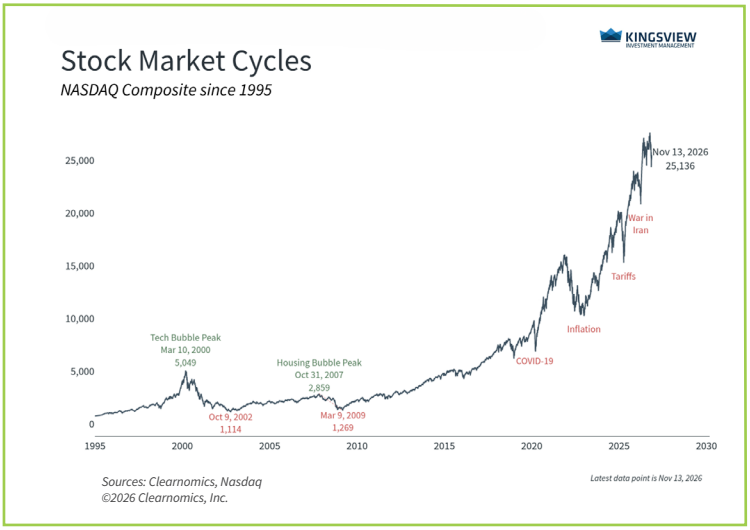
Portfolio Manager Insights

What Leadership Changes at Nvidia Mean for AI Trends

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Investment Committee

Technology and AI-related stocks have experienced a period of volatility since the Nasdaq reached its all-time high in early October. The midterm election first raised questions about the pace of data center construction across the country. Now, investors are digesting the news about Jensen Huang, the co-founder who has led Nvidia since 1993, including leadership changes, espionage as part of the AI race between the U.S. and China, and how Nvidia will navigate the period ahead. While the story is still unfolding, it's not surprising that this news has captured investor attention given Nvidia's central role as a supplier of chips to the AI industry.

LEADERSHIP CHANGES CAN CREATE SHORT-TERM UNCERTAINTY



While stock-specific events can create uncertainty, it is important for long-term investors to understand how it affects the underlying risks and opportunities in the broader market. These events highlight topics that many investors may not always focus on, including corporate governance, succession planning, and transparency. These are just as important when it comes to long-term investing as market performance, valuations, and other factors on which investors tend to focus.

In particular, corporate governance refers to the rules and oversight that determine how a company is directed and held accountable. These factors matter even more when a single company plays an outsized role in the market and the economy. **How can investors make sense of these developments while maintaining a long-term perspective?**

As the accompanying chart shows, tech stocks have pulled back since their October 6 peak.[1] It is not unusual for technology stocks to experience declines of this kind, even during strong long-term cycles. This is because their valuations depend heavily on expectations for future growth, which can shift quickly with investor sentiment, interest rates, and other factors.

The idea that a stock's price reflects all available information is a cornerstone of modern finance. However, when a long-serving leader departs unexpectedly, investors may have to reassess everything from strategy to execution, which can take time and creates uncertainty even when a company's fundamentals remain strong.

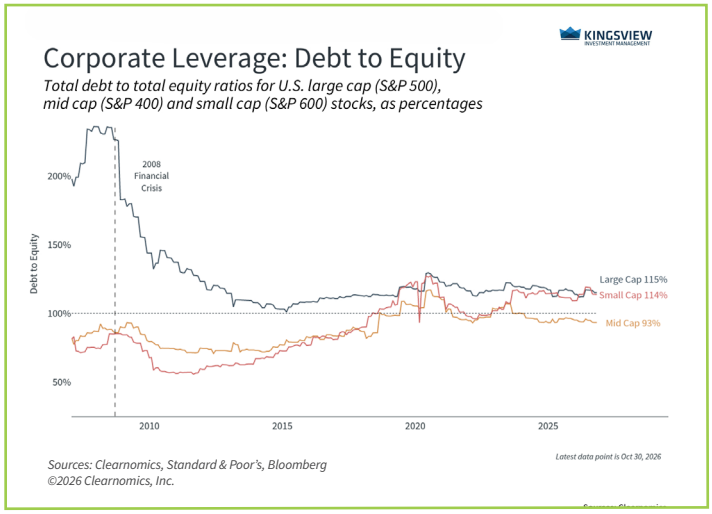
Why does this matter beyond a single company? The larger a company's role in an index and an industry, the more a company-specific development can influence the broader market. The Magnificent 7 accounts for over one-third of the S&P 500, so swings in a small group of stocks can affect the overall index.[2] Nvidia also sits at the center of the AI supply chain, which means news about the company can ripple through chipmakers, cloud providers, and many other stocks.

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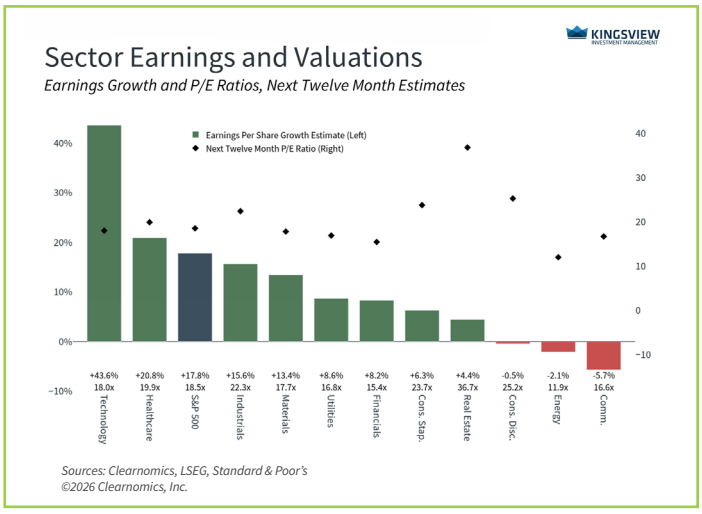
This is hardly the first time a company has faced questions about a founder or long-serving CEO, with Apple perhaps being the most famous example. In 1985, Apple's board had not set clear boundaries between co-founder Steve Jobs and CEO John Sculley, and the resulting conflict led to Jobs' removal. Years later after returning, when Jobs faced health issues, Apple built a formal succession plan that moved Tim Cook into the CEO role in 2011. A more recent parallel comes from the AI industry itself. In 2023, the board of OpenAI removed CEO Sam Altman, who returned four days later.

In the last century, corporate governance standards for public companies have evolved significantly. This is partly in reaction to periodic crises that have driven board independence, regulation, and other risk management tools. Whether or not corporate governance has a direct measurable impact on investment performance, these rules are put in place to protect investors.

CIRCULAR DEALS HAVE RAISED QUESTIONS AMONG INVESTORS



VALUATIONS REFLECT HIGH EXPECTATIONS



One concern among investors is the rise of so-called "circular deals," arrangements that have become increasingly common in the AI industry. These include cases where Nvidia finances, invests in, or guarantees obligations for customers and partners, such as AI model developers and cloud providers, that in turn buy its chips. This can seem circular in that Nvidia is often providing the capital that allows the customer to buy its products.

Whether this is truly circular, however, depends on whether the customer is economically viable. In these situations, a more traditional way to view these arrangements is known as "vendor financing," where a supplier helps to provide financing for customers to pay for its products. Whether vendor financing works depends on if demand for the customer's own products keeps growing. These arrangements can help the industry scale to meet that demand more quickly. However, if demand slows or wasn't there in the first place, the risks can compound, since the same companies are both customers and investments.

The scale of these commitments has grown rapidly across the industry. For example, Nvidia's most recent quarterly filing disclosed about $530 billion in off-balance sheet commitments and guarantees, which are future obligations that do not appear as liabilities on the balance sheet.[3] This is up from $184 billion the prior quarter and far larger than the roughly $91 billion in debt and obligations on its balance sheet. Its investment portfolio has also grown to about $128 billion, much of it in private stakes in AI companies that cannot be quickly converted to cash.

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At the same time, the company generated about $127 billion in free cash flow over the past twelve months and holds about $22 billion in cash against $33 billion in total debt. Traditional leverage measures, such as the debt-to-equity ratio, only capture what appears on the balance sheet. This is why it is important to consider both sides of the ledger when evaluating these commitments and looking for potential market risks.

Many of today's corporate compliance rules exist because major companies once experienced severe breakdowns in oversight. Enron is the clearest example. Its executives used complex side companies, known as special purpose vehicles, to intentionally hide billions in debt and create the appearance of revenue. When this came to light in 2001, Enron went bankrupt, wiping out over $60 billion in shareholder value along with employee retirement savings.

Congress responded with the Sarbanes-Oxley Act of 2002, which requires strict internal controls and public disclosure.[4] Lehman Brothers, which concealed billions in debt off its balance sheet ahead of its 2008 bankruptcy, is another reminder of why this matters. The key distinction today is transparency. Unlike Enron's hidden structures, Nvidia's commitments are disclosed in public filings, allowing investors to evaluate the risks for themselves. This does not mean they carry no risk, but disclosed risk that investors can evaluate for themselves is very different from hidden risk.

The rapid developments in technology and AI stocks, including the buildout of new data centers, have pushed earnings higher. While it's natural to compare this era to the dot-com bubble, they are different in important ways. Unlike the dot-com bubble, which created many loss-making companies while valuations hit euphoric levels, the current market expansion is supported by earnings growth. This has helped valuations, which remain elevated but have improved on many measures, as the accompanying chart shows.[5]

Investor enthusiasm is also visible in new offerings. Anthropic's initial public offering, or IPO, is expected to begin trading on November 19 and is reportedly about six times oversubscribed, meaning demand for shares far exceeds the amount being offered.[6] This reflects both strong demand and high expectations across the industry.

It's important to remember that valuations are not a market timing tool. Instead, they matter when deciding on the right mix of assets in a portfolio. None of this is to say that AI is not transformational. Rather, it is a reminder that portfolios should not depend on any single company, theme, or individual leader, which is why balance across sectors, styles, and asset classes remains so important.

The bottom line? Leadership changes at Nvidia highlight the importance of corporate governance and transparency, especially when a few companies have an outsized impact on markets. Maintaining a diversified portfolio aligned with long-term goals remains the best way to navigate these periods of uncertainty.

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