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Welcome to the Party, Pal

Doug Winslow: It is a pleasure to be here with you today. I was told to talk about the entire landscape of technology investing, answer all of your questions about AI, make it engaging… oh yeah, and do it all in less than 20 minutes. I said, well, where's the challenge?

You may be wondering about my presentation's title. This is a quote from the 1988 movie Die Hard, starring Bruce Willis. When thinking about investing against the backdrop of the digital revolution and now, potentially, the AI revolution, it reminded me of this movie. Let me explain. Die Hard is about a cop, played by Bruce Willis, who is visiting his wife at a corporate holiday party, when a group of terrorists takes over the high-rise building where the party is being held. There is a memorable scene where Bruce Willis is desperately trying to get the attention of a patrol officer, who is leaving the building after scanning the lobby and thinking it was a wild goose chase. Bruce Willis shoots out a window, throws the dead body of one of the terrorists on the patrol car, and, for good measure, shoots at the front of the car as well. He then gives the iconic quote: "Welcome to the party, pal."

This phrase captures how I felt 10 years ago as we stared down the digital revolution, the digitization of everything, and the ubiquity of on-demand computing. And this is currently how I feel about AI. Bruce Willis can be a reminder that we are part of this. This is the world we are in, and now we have to deal with this head-on. When these changes occur, we need to be disciplined and not float in the clouds of hype, but we also must not have our heads in the sand.

Let's look back and consider these two extremes in the context of the internet revolution during the dot-com era. Let's start with having our heads in the sand, being oblivious, or thinking something is a wild goose chase. This was the state of the patrol officer before Bruce Willis fully drew his attention to the mayhem going on inside the building.

Here's a clip that illustrates this thinking with David Letterman and Bill Gates from 1995.

I like the line from David Letterman: "It's easy to criticize something you don't fully understand." And then he did.

Let's go to the other extreme. Avoiding pure excess. Here's a commercial from the dot-com boom period.

Pets.com – Please don't go

Yes, that was the Pets.com Super Bowl commercial from January 2000. Yes, they spent more for that commercial than they generated in revenue the year prior. Yes, the company went bankrupt nine months later.

Sustainable competitive advantages, which we commonly refer to as moats, and business economics matter. That isn't a groundbreaking statement. However, it is an important reminder when there are important trends underfoot. The investment industry is tough. The markets are forward-looking, so an insight into the future isn't enough. We don't want to overlook something important, but we do need to apply some filters and be careful how we prioritize our time and energy. We should be knowledgeable about the important things and recognize areas of big value creation. We also need to stay disciplined. Companies ultimately need to earn the market capitalization that they have. Simple guardrails, yes. But very easy to forget when something new, shiny, and spectacular is being waved in front of you.

Die Hard has another lesson for us. I watched the movie again last month for you, for this speech, and not because I think it is one of the greatest movies of all time. There is a scene where Bruce Willis sees trouble as the FBI is plotting entry into the building. Now having radio communication with the patrol officer outside, he yells, "What's going on outside, Al?" The patrol officer, who by now realizes that Bruce Willis has a better read on the situation than the LAPD or the FBI, retorts: "Ask the FBI. They've got the universal terrorists' playbook, and they're running it step-by-step." In case you've never seen the film, the FBI wasn't dealing with a group of terrorists but rather a sophisticated heist orchestrated by a mastermind thief.

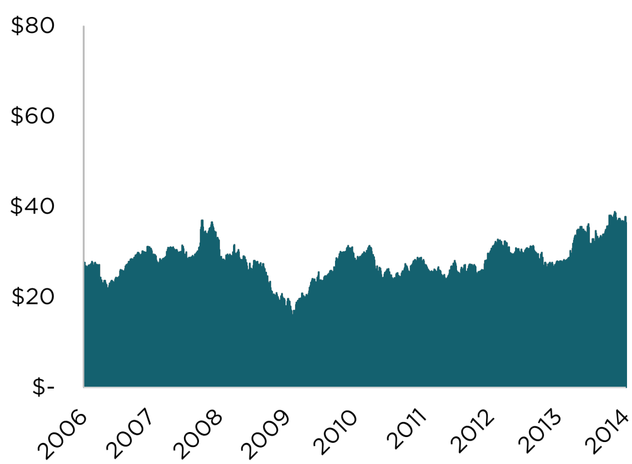
I'm reminded of how easy it can be for a value-minded investor to be too rigid with a certain playbook, even when the situation calls for something else. This last decade has not been easy for value-minded investors, especially in U.S. large caps. The economy has been transforming, with an unusually large number of companies growing at above-average growth for long periods of time, while other companies are struggling to keep their footing. The digital economy is a bit different. It is a process for value-minded investors to come to terms with this change.

Now to the meatier part of the discussion. Let's talk about some lessons we have learned so far in the digital world and what opportunities are in front of us. Let's start where a value-minded investor tends to gravitate: a low multiple. Margins of safety tend to be mirages if you are dumpster diving in technology stocks. It isn't easy to get a business back on track when the ground is shifting. Even our original purchase of Microsoft, which had one of the greatest monopolies of all time, when it had a low multiple, wasn't successful because it was a value purchase. Let me illustrate.

This cover of Fortune magazine from 2006 includes a caption from an article about Microsoft's campaign to conquer the web. In reality, it had already lost the war to Google. The wrong strategy at that point.

It was essentially dead money for eight years as the company struggled with its strategy – being Windows-centric and trying to force Windows on all devices, including buying the cellphone business of Nokia. The world had changed.

Figure 1. Microsoft's Share Price Since Burgundy's Initial Purchase

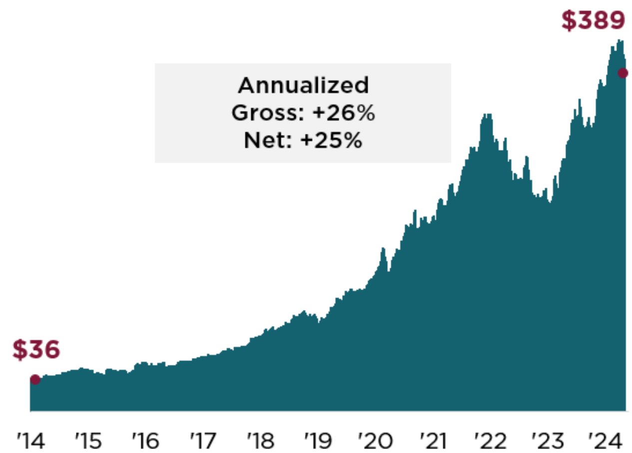


Source: FactSet in U.S. dollars.

It was only after a management change, when Satya Nadella became CEO in 2014, that things started to turn around. Microsoft benefitted immediately from a strategic pivot to a productivity and platform company for a mobile-first and cloud-first world.

It also coincided with a big shift to cloud-based computing. A nice tailwind always helps. In any case, it was only after this change that Microsoft's stock really performed.

Figure 2. Microsoft's Share Price Since Satya Nadella becomes CEO



Source: FactSet in U.S. dollars.

The buy-it-cheap-and-figure-out-the-thesis-later method tends not to work in technology. Even with Microsoft and a monopoly-like core business, investors were better off waiting until there was a clear thesis. Eight years is a long time to wait, especially for something that may or may not happen.

Let's move on to some company lessons. The moats in the technology space are a little different, and the payoffs can be much bigger. There are lots of lessons. I'll share a couple.

A big takeaway is that platforms and ecosystems are some of the most important moats. They really increase stickiness. These platforms and ecosystems not only deepen the moat, they also enable real cross-selling to customers. Users of Microsoft Office Productivity Suite benefit from tight product integration.

There can be smooth connectivity between the solutions where the workflow is linked together, leveraging Microsoft's position in core operating software. This is more than just a bundle. This is integration at a consumer level. Picture the Apple ecosystem in your life. The iPhone is the sun in this solar system, with the watch, iPad, iCloud, and various services potentially in that orbit. The more enmeshed you are in that ecosystem, the harder it is to remove yourself from it. Increasing returns with scale and size are also more prominent in this economy. Products or services can get better with size because of natural network effects, or as more and more data is used to improve the product or service. The Waze app is an example of this. It became better with more users. As a result, it is even more important in technology to focus on leading positions or, put another way, dominate.

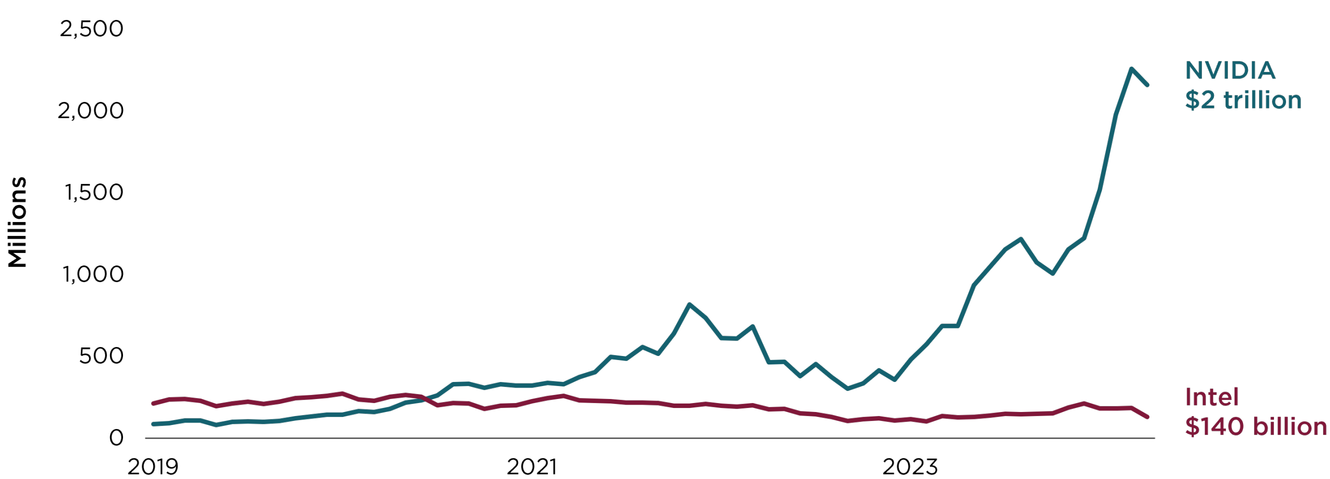
Given these moat characteristics, the ability to scale quickly and the ability to dominate a market is even more important to be aligned with the right management teams and to be on the winning side of a shift or competitive battle. We have seen this most recently in semiconductors with Nvidia and Intel. Intel supplies the critical components into AI data centres. Look at the difference in the market value — $2 trillion!

Picking the right company and management team within a growing area of tech is very important.

Today's biggest companies are very different from how the biggest companies of 25, 50, and 100 years ago looked in terms of growth, margins, free cash flow generation, etc. The ability to monetize and expand their offerings to the user base is unparalleled. Digital economics are unique for the dominant companies. We do need to be more aware of the upside potential.

There is an irony here when we talk about total addressable markets or TAM, which refers to the size of the market the company is selling into. Entranced by the size and success of big tech, companies and investors have embraced the TAM concept, sometimes to ridiculous extremes. One of our portfolio companies likes to refer to TAM as a "totally artificial metric." The irony is that the companies that are most vocal about TAM actually fall into the totally-artificial-metric category, whereas you rarely hear the most successful large-cap tech companies use that language with investors.

Figure 3. Market Capitalization: NVIDIA vs. Intel



As of April 30, 2024. Source: FactSet in U.S. dollars.
Logos are shown for illustrative purposes only.

There is an interesting article about the internet from Fortune magazine in April 1994. In the article, Bill Gates noted, "There will be an efficiency in this marketplace that people will have to wrap their minds around." Boy, did he nail it with that comment. That comment still resonates today and captures the essence of the lessons I just noted. And this is also a great segway into a topic on everybody's minds, artificial intelligence.

Some of you may recall that when I spoke at Client Day in 2018, I showed a clip from Steve Jobs talking about humans being toolbuilders. He discussed an article in Scientific American that compared the efficiency of different animals' movements over distance. Humans on their own didn't rank particularly well. But, on a bicycle, humans went all the way to the top of the list. Steve Jobs then related how computers, looked at as tools, can amplify our abilities to spectacular magnitudes. He came up with the beautiful metaphor that computers are the bicycles of the mind. This is still a very important metaphor to keep in mind as computing continues to progress, including now with AI. We can amplify our abilities to spectacular magnitudes – digital bits being easier to move around than regular atoms. AI should also help society improve white-collar productivity.

Generative-AI is a big change in what we can do with this "computer deal" as David Letterman called it. Here's a quote from Jensen Huang, the co-founder and current CEO of Nvidia, that has had a big impact on me.

> **"The vast majority of computing today is a retrieval model… In the future, the vast majority of computing is going to be retrieval PLUS generation… [Computing] hasn't been reinvented in 60 years. This is why it is such a big deal."**
>
> **- Jenson Huang**

We can already see the early stage use cases with this concept of "generation" vs. "retrieval." Generative AI can help streamline workflows; the customer experience; how companies market, merchandise, sell and provide customer service; how they re-imagine products; and yield efficiency in development costs. We are seeing real examples.

Investors are spending their time thinking a lot about AI winners. But the internet has taught us that with change, there is both value creation and value destruction. At Burgundy, we are thinking about both the winners and the losers.

Let me start by noting that we have time. Why do I say that? Let me explain a comparison from a different era that I have found useful.

In a speech in the early 2000s, while Jeff Bezos was trying to defend and endorse the power of the internet, he compared the internet to the invention of electricity. A lot of people were comparing the internet at that time to the Gold Rush. The California Gold Rush in the mid-1800s was real, and people did get rich. And it was indeed a rush because there was only so much gold that was accessible to the individual panhandlers. It lasted seven years, and then it was over. With electricity, however, there was a long wave of innovation that followed. Thomas Edison got a patent for the electric light bulb in 1879. What about other applications? It was slow going. It wasn't until 1890 that the first electric fan was invented. The "golden age" of appliances lasted approximately 60 years, from 1890 to 1950. And think about everything else that was invented because of and around electricity. But it took time.

There is a cool tagline from a Sears ad in 1917 inviting consumers to "Use your electricity for more than light."

The internet, and now AI, are also different than the Gold Rush. There should be an enduring wave of innovation and value creation.

Two of the biggest winners from the internet, Google and Apple, got late starts. Google was founded in 1998 and didn't go public until 2004. It continues to grow double digits to this day. Similarly, the iPhone wasn't invented until 2007. Sometimes the beneficiaries of a tech change are incumbents in completely different fields. Coca-Cola, for example, was a big beneficiary of the invention of refrigeration. Coke is more refreshing served cold.

So, one lesson is that we don't need to buy in on day one to do well. Electricity and the internet taught us that, and I believe this will also be true for AI. And yet... what are we doing today?

Some of our companies are benefitting from the big data centre buildouts, like Carrier, which provides cooling solutions for the heat-intensive computing process. More directly, we own Microsoft, Alphabet, and Amazon. All three benefit from embedding AI into their services, and these companies also have the three leading cloud computing platforms outside of China. They each have strong competitive advantages: computing scale, go-to-market coverage, a large installed base, multiple products and services that complement one another, data advantages, etc. Once these companies get customers to use their AI platform and tools, it pulls in many of their other services. Recall the Apple ecosystem I shared earlier. For example, half of Azure AI customers – Azure being Microsoft's cloud computing platform – are now also using Microsoft's data and analytics tools. They should all benefit from AI activity.

Looking at the present moment, where are we valuation-wise? (See Figure 4.)

The valuations of our holdings are much different than blue-chip tech during the dot-com period. One hundred times earnings back then for Cisco. The current earnings of portfolio holdings Microsoft, Alphabet, and Amazon are clean, the balance sheets are rock solid, and there is also significant investment for growth. Having said that, the share prices of all three have increased significantly. We are not saying they are bargains. The valuations don't look crazy either. In any case, we will take action and rotate into other opportunities when those situations arise.

Figure 4. Tech Valuation - Dot Com vs. Today

December 31, 1999

Company	Price-to-Earnings NTM
Cisco Systems	101x
Oracle	89x
Microsoft	69x

April 30, 2024

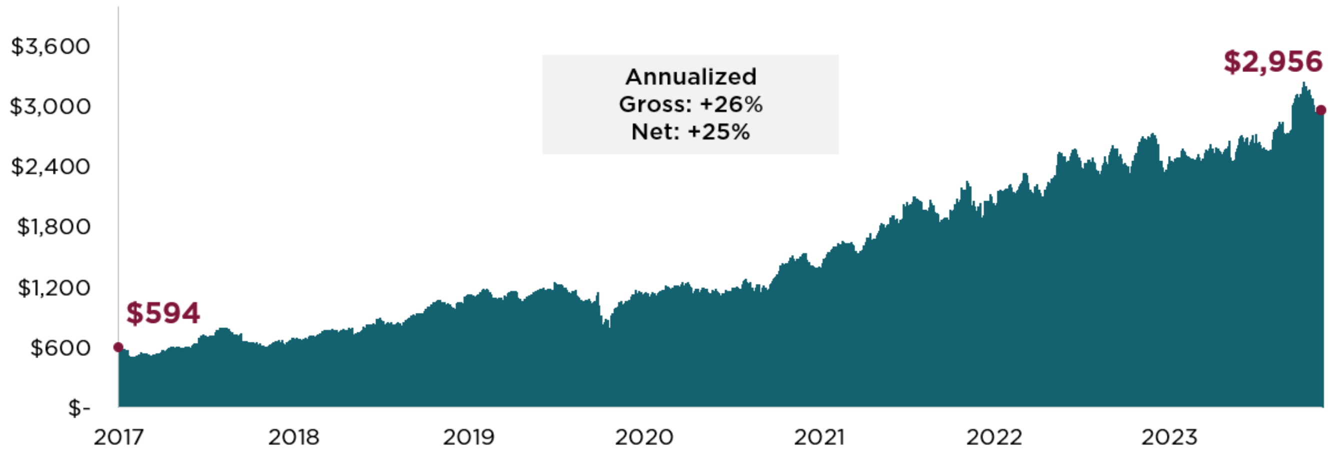
Company	Price-to-Earnings NTM
Amazon	36x
Microsoft	31x
Alphabet	21x

Source: Bloomberg and Burgundy research.

One final point. We must remember that technology stocks aren't the only place to find big winners, even though technology tends to get the most attention from mainstream media. Burgundy has examples of this across industries and geographies in our history. And this is true today too.

Steve Boutin and the U.S. small/SMID team have shined brightly in this regard. One example to highlight is Copart. Copart provides online vehicle auctions and vehicle salvage services. A company doesn't get sexier than that. Look at this stock chart. The 11-year annualized compounded stock return is 28%. That's the same as Microsoft.

Figure 5. Autozone's Share Price Since Amazon's Whole Foods Acquisition Announcement



As of April 30, 2024. Source: FactSet in U.S. dollars.

In U.S. large cap, AutoZone is an interesting example. AutoZone is an auto parts retailer. The market had been concerned about the Amazon threat. And it, along with the rest of retail, sold off on the day that Amazon announced its acquisition of Whole Foods in June 2017. But auto parts retailing has thus far been largely insulated from the online threat due to service needs and obscure part availability with convenience, in addition to filling the needs of repair shops. We have witnessed this customer service firsthand when we visited these stores on our research trips.

Since that time, earnings have continued to grow meaningfully, shares outstanding have shrunk through buybacks, and the stock has done very well. The big lesson here, to reiterate, is that there are also value-creation opportunities outside of technology companies.

To wrap up, the march of technology continues. While the scale, moats, and magnitude of the payoffs can be different, the sport is the same, and the playbook can be adapted and refined for the team we are playing. The tech revolutions tend not to be gold rushes with short, abbreviated windows to make money. We have some time. And we are studying the developments closely. Over the long term, stock market growth tracks earnings growth. We do need and want earnings growth and to participate in areas of value creation. To do that, we need to invest in the era we are in, including but not exclusive to technology companies. Thank you.

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