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Thoughts From Our Chairman - Alfred B. Van Liew

It's all about productivity. Many thought the telegraph would put people out of work. Not at all. Rapid sharing of information propelled us into a new era.

In this issue of the As We See It, our associate Joseph Healy discusses today's telegraph.

“AI” and the Jevons Paradox

Can this 19th century economic theory provide any insight into today?

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Artificial Intelligence (“AI”) and its potential implications dominate the current discussion in our changing world. We are in the early innings of AI adoption and just how transformational AI may be is widely debated. For purposes of this discussion, I will take a “glass is half full” view of AI and while it might seem like a threat, it could portend economic opportunity when viewed through the lens of the Jevons paradox.

Most readers have likely never heard of the Jevons paradox, but recently it's been popping up in the broader media. The Jevons paradox dates back to 1865 when English economist William Stanley Jevons described how industrial advancements made coal more efficient to use. However, rather than decrease the actual consumption of coal, it spurred an increase in the use of coal. By definition, the Jevons paradox occurs when improvements in resource efficiency led to an overall increase in resource consumption, rather than a decrease.

Investment in AI is skyrocketing and the performance of companies most directly benefiting from the AI build-out are leading the equity market. Opinions abound over what AI adoption will mean, and the widely anticipated benefit to enhance the bottom line of many companies in the broader economy has yet to be realized. Currently, the strongest returns remain concentrated in what some might call “the picks and shovels” investments, those closely related to the build out of data centers and infrastructure to support expanding AI development. The expectations for future demand of data storage and energy continue seemingly unabated. The spending of the largest cloud computing and data management service providers (hyperscalers) now exceeds 50% of S&P 500 total capital expenditures and is rising. There is no consensus view on how our world will be impacted by this enormous wave of innovation. Perspectives range from “wide swaths of current jobs will be transformed/decimated” to one where “AI will help companies better leverage technology to achieve efficiencies and boost bottom line corporate profits”.

One might expect such change could result in a decline in employment opportunities. Applying the Jevons paradox, instead of a decrease in jobs it could result in more human interactions rather than fewer. Growing segments of the economy, as a whole, could potentially serve more customers through more businesses being created with the barriers to entering those markets

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eroding. Instead of industries shrinking, AI may fuel growth overall. At least, that is what we hope will happen.

Look at how the Jevons paradox might apply to other examples, such as call center employment. Many countries, like India and the Philippines, have witnessed dramatic call center job growth over recent years. Common wisdom has long viewed such growing populations, and the potential future consumption these emerging market economies promise, as an opportunity. Yet with the emergence of AI, you now read concerns that these growing populations, with economies dependent on lower skilled jobs like call centers, will suffer. This view represents a reversal. What was once seen as a positive driver for consumer demand from emerging market population growth can now potentially be seen as a negative. But in applying the Jevons paradox to this example, we may be seeing better outcomes since business processing employment growth in those countries still continues to rise.

Keep in mind that the Jevons paradox is just an economic theory, but looking at the past it seems best suited when applied to transformational changes. Other examples to view through the lens of this theory include the notion that more fuel efficient vehicles might lead people to drive more, which can be both a positive and a negative. Higher yielding crops and better irrigation might lead to greater agricultural output. In fact, agriculture once represented 40% of US jobs and today is now under 2%. Was that a positive to push agriculture workers towards other jobs/fields? In hindsight, probably so. But other examples of unintended outcomes are that cheaper fuel or better access to potable water might deemphasize efforts to be more efficient resulting in waste, which is a negative.

Implied within the Jevons paradox is improved productivity and how a more efficient allocation of resources eventually flows through to the bottom line of company earnings. That benefit would accrue to the winners while others may be left behind. As an investor, it will always eventually be earnings that drive performance and stock prices.

We recently attended a conference where a widely regarded equity fund manager offered some interesting insights. Over the past six months, specifically because of AI and its implications, his historically held views about the desirability of companies and industries with outsized profits and defensible business models had changed. He now sees a risk that industries or companies producing outsized profits represent an opportunity for AI to identify and now more easily enter those markets as a disruptor. These firms' protective "moats" may not be as defensible, as they now face more competition with likely lower profits. Are the formerly less attractive investments under the old paradigm now more attractive, and vice versa?

This discussion doesn't change the primary tenets of investing, which still come back to broad diversification, investing to appropriate time horizon(s), a suitable risk threshold and risk-adjusted returns commensurate with those objectives. Investors need to be aware and open minded that in the evolving AI environment "things could be different this time". AI adoption and its impact will likely mean greater market volatility (while so far that has not been the case), too. But with AI's anticipated far-reaching impact it needs to be on the radar of every investor.

P.S. AI did not write this piece. Maybe we humans are necessary – for now.

We would be delighted to meet with you to share comments about this article, or to review your portfolio in detail.

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