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Active investing and AI: Why managers could be looking beyond growth stocks

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Vanguard's megatrends research examines how fundamental shifts in technology, demographics, fiscal deficits and debt, globalization, and more may shape the economic landscape, future markets, and broader society. We use the Vanguard Megatrends Model™ to assess over 130 years of history to isolate the drivers and impact behind each megatrend and assign probabilities to future financial and economic scenarios.

One such outcome suggests a future that too few are talking about, one in which technology as a megatrend, specifically artificial intelligence (AI), transforms the way we work, driving increases in productivity and economic growth.

In this series, Vanguard Global Chief Economist Joe Davis, Ph.D., answers questions to help investors understand the implications of his research and how investors should respond.

What might the rise of AI as a transformational force mean for investors using active strategies?

Davis: If we're right about our scenarios, and AI is transformational, then active strategies will need to outperform in an environment where growth is plentiful, and the source of earnings growth is broadening. If AI fails to be transformative, which is our downside scenario, then active strategies will need to navigate a disappointing earnings-growth environment with, possibly, an earnings-multiple contraction in the stock market.

Within active strategies, we should also distinguish between active fund managers and asset allocators. Typically, the biggest value-add for an active fund manager is security selection. They look out over various time horizons to take advantage of specific company risks that may not be fully priced in. But they're generally less focused on macro bets.

Asset allocators, on the other hand, are more attuned to the changing macro and return environments. Their view would inform how they allocate assets across stocks, bonds, and cash. So the focus is on the portfolio's longer-term strategic asset allocation, and some complement that with a more tactical or time-varying allocation overlay.

How do those two approaches integrate with your AI-megatrends research?

Davis: Long term, the most important decision is how investors are allocated across and within asset classes. So, it's important to get that right, and then determine whether and how much active exposure you want and what type of active fund managers would be suitable for the environment. If AI is transformative and we have a high-growth environment, then we believe there's going to be some outsized gains from companies that emerge inside technology, as well as outside technology that harness AI. In this environment, great active equity managers would be those who are early to identify these future winners—the next Amazon and NVIDIA—and potentially outside of the tech sector.

If AI ends up disappointing, and there's an economy-wide dearth of growth, it's possible that the market may favor a different style of active managers: those who can identify a solid business at a great price, rather than a great business at an acceptable price. Most active managers have a style they tend to adhere to. So, active talent who would shine would be somewhat different depending on which scenario materializes.

So how about asset allocation?

Davis: If AI does become a transformative technology, our research indicates that the strongest productivity or growth factors over the longer term would be in the U.S. If AI is indeed transformative, its impact will likely spread beyond the tech sector. So, if you're open to taking on risk, consider increasing your overall equity exposure rather than leaning into just tech. I'm aware that we're going into this with the U.S. already being the most expensive market in the world from a valuation perspective. But, in the upside scenario, the return expectation would be coming from continued earnings growth—which likely comes from a broadening of return sources beyond tech. In this vein, a value tilt could be an interesting consideration.

If AI disappoints, there is a measurable downside to growth stocks and an increased opportunity for value to outperform growth. Beyond these strategic considerations, in both scenarios, a value tilt has some merit because value could provide a hedge to overall equity exposure in times of cyclical economic downturns or recessions. Taken together, investing solely in tech stocks right now appears risky due to their current valuations. These are some considerations for investors looking to tilt their strategic allocation.

Takeaways

- **Don't count out value:** If AI becomes transformational, exciting earnings growth may broaden beyond the tech sector. If AI disappoints, a value tilt may prove more defensive than growth due to the current tech stock valuations.
- **The nature of active outperformance will depend on how AI plays out:** If AI brings economy-wide growth, active managers who can spot the "winners" early on are likely to have an edge. If AI disappoints and growth is hard to come by, active managers who are great at bargain-hunting may have an edge.

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