The Crescent Group

(214) 775-6401
us.rbcwm.com/thecrescentgroup

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Carsten Frederiksen, CFP®
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
Direct: 214-775-6401
NMLS#: 1321563 City National Bank

Paul Hendershot
Senior Vice President
Financial Advisor
Senior Portfolio Manager
Portfolio Focus
Direct: 214-775-6430
NMLS # 1370978 City National Bank

Andrew Ielmini, CPFA®
Financial Advisor
Direct: 214-775-6448

Lindsey Vickers, MBA
Senior Registered Client Associate
Direct: 214-775-6458

The Crescent Group website

June 2023 Crescent Commentary

It's truly shocking how fast financial market sentiment can change. In March, as several prominent banks failed, many investors wondered if we might face another financial crisis. Less than three months later, we've seen a return to irrational exuberance, as FOMO regarding artificial intelligence – or AI – replaces careful consideration of risk. It's no wonder that Warren Buffett has described the stock market's behavior as that of a "drunken psycho".[(1)]

Given these two dramatically opposed investment climates, what's an investor to do? We know that trying to jump from one investment strategy to the next doesn't work. We've shown the data before. DALBAR has conducted the largest ever study of investor behavior. Trying to move in and out of investments based on the prevailing mood has caused investors to get a 2.6% annual return over the long-term, rather than the 6.8% annual return their allocation would have provided if they remained invested in their long-term strategy. Given this data, our Group recommends an approach that's likely to do reasonably well no matter what happens. Because "no matter what" will happen occasionally.[(2)]

So how can investors position themselves to benefit from AI so that they don't feel like they're missing out, while also maintaining the right diversification to protect themselves when the exuberance ends? (Let's not forget what happens when exuberance ends – we saw it last year, and it was ugly). Part of our approach involves owning assets of perceived future AI "winners", which are those companies currently expected to capture outsized profits from AI. As with any emerging technology, investing directly in AI is a highly uncertain proposition in terms of how profits will play out over time. The key is to diversify strongly. While investors may be tempted to over allocate to an asset after it's quickly gone up in price, that asset can and often does end up going quickly the other way at some point.

The second part of our strategy is to invest in businesses that will indirectly benefit – in terms of efficiency, productivity, and profit margins – from successful future application of AI. Over the past many decades, we've seen a large number of quality companies continuously increase their profit margins as a result of implementing new technologies that have increased their efficiency and productivity. The same thing will happen with AI.

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From a big picture standpoint, this strategy for capturing the benefits of AI is similar to our strategy for capturing the benefits of emerging markets. Emerging markets are highly volatile, and investing directly in emerging markets comes with many risks. Rather than taking on those risks directly as investors, we capture the benefits of emerging market growth indirectly by investing in companies that sell to emerging market consumers. For example, almost all of our consumer products investments have a large portion of sales in emerging market economies in Latin America, Africa, the Middle East, and Asia. These emerging markets represent the fastest growing regions for these companies. And so we can benefit from the high growth of emerging markets without taking on the direct risks of investing in them.[3]

One example of how this works is with the war in Ukraine. Almost all Western consumer products companies announced their exit from the Russia market after Russia invaded Ukraine. This had only a small, say 1% impact, on the total sales of most of these companies. As a result, we as investors didn't notice the impact of a 1% reduction in sales in companies whose sales grew 5% to 10% elsewhere around the world. Meanwhile, these companies continued to experience double-digit sales growth in other emerging markets. This shows the benefit of letting the highest quality companies invest in emerging markets and emerging technologies for you, rather than directly investing in them. If you had a direct investment in Ukraine or Russia, it could be a total loss. Instead, we have investments in global companies that had small investments in Ukraine and Russia, and the companies continue to do very well. And so this will be the cornerstone of our strategy for capturing the benefits of AI as well: yes, we will own some direct AI investments in measured and diversified amounts. But rather than exposing you to outsized risk by over allocating to an industry with great profit uncertainty, we will focus on investing in the highest quality companies that will benefit from AI to increase their productivity and profit margins over time.[3]

Now that we've covered our financial topic for the month, please join me in congratulating Carsten Frederiksen on his recent award as an AdvisorHub Advisor to Watch in 2023. This award goes to a select number of financial advisors nationwide. AdvisorHub ranks nominees based on the size, quality, and growth of their practice, as well as their character and professionalism. Carsten stands out as an example of professionalism and integrity and is someone who stays true to his and RBC's core values. Some of you may recall that Carsten previously received the award of State-by-State Top Next-Gen Wealth Advisor by Forbes / SHOOK. We are very proud that Carsten has received recognition for his commitment to quality work for our clients.

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Paul Hendershot | Carsten Frederiksen, CFP® | Andrew Ielmini, CPFA | Lindsey Vickers, MBA

Sources:

(1) Yahoo Finance
(2) RBC Wealth Management
(3) Company reports