UBS

6 May 2026, 06:00 UTC
Chief Investment Office GWM
Investment Research

Should investors review their AI investments?

Investment strategy insights

Author: Matthew Carter, Strategist, UBS AG London Branch

- We retain conviction in the long-term return potential of AI. But we stress the need for a balanced and diversified approach across the AI value chain.
- Investors with just one or two AI stocks in their portfolio should look to diversify, or can consider letting others navigate the fast-moving AI world for them.
- Certain tools can help underallocated investors build AI positions while limiting losses or owning shares at lower prices than today's.

Source: Shutterstock

Markets outside of the US, especially in Europe and the Middle East, are being driven by oil prices, the developments in the Iran conflict, and the outlook for the European Central Bank.

But investors with a global equity allocation care about the performance of AI companies and those applying AI to boost business performance.

What can we learn from first-quarter earnings reports from major US and Asian technology firms?

Coming into the earnings season, CIO analysts covering the AI Transformational Innovation Opportunity (TRIO) highlighted three key areas of focus: 1) the health of core businesses; 2) the direction of travel for capital expenditures; and 3) commentary around returns on capital. AI-related demand remains strong in the US, as evidenced by the significant acceleration in cloud revenue growth and the huge increase in backlogs. The stronger demand environment has prompted some companies to increase data center capex. And outside of tech, a number of electric utility companies indicated that they are accelerating discussions with the hyperscalers for power supply, reinforcing the long-term demand trends.

But investors are not entirely convinced that higher capital spending on artificial intelligence will pay off. They are increasingly looking for a disciplined approach to capex, supported by strength in underlying core businesses and signs of monetization that point toward returns on capital invested.

We retain conviction in the long-term return potential of AI. But we stress the need for a balanced and diversified approach across the enabling, intelligence, and application layers—including semiconductors and chipmaking equipment, power and resources, infrastructure, and selected companies in the US, Asia, and Europe that we believe stand to benefit from AI adoption.

Investors with one or two AI-linked stocks in their portfolio can consider revisiting positions and seeking diversification. Tools for doing so may include following CIO's AI stock selection and leaving others to manage the fast-moving market and shifting value chain. Other approaches can include seeking building blocks of exposure to AI stocks or to look for active approaches that seek to identify smaller numbers of stocks than, say, buying an index.

Investors who have too little exposure to AI stocks relative to long-term plans can also consider structured strategies. These approaches use certain types of financial instruments called derivatives. Structured strategies may offer investors flexibility and the potential ability to tailor their equity exposure according to their market outlook and risk appetite.

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It is important that investors understand the unique features and characteristics of derivatives before investing, especially how structured strategies fit as part of a well-diversified portfolio and a wider financial plan. For some investors, there may be alternative tools to structured strategies that better match objectives and risk tolerance.

Risk-averse investors looking to put cash to work in AI-linked stocks can consider a tool called a capital preservation note. This type of investment may help to limit potential losses in the event of renewed volatility.

Risks to this type of tool that investors must be willing and able to bear include issuer default (the risks that the issuer of the tool cannot repay investors), liquidity constraints (a more limited ability to sell the tool in periods of market stress), and the need to hold the note to maturity for capital preservation features to apply (with capital preservation only applicable at expiration.)

Risk-tolerant investors could consider a tool called a reverse convertible as a means to generate yield in parts of the equity market where implied volatility remains above average.

Setting the strike price at the level where the investor wants to buy can allow them to "wait out" uncertainty and potentially acquire the asset at a discount.

Risks to this type of tool include loss of capital if the asset falls significantly, issuer default, limited liquidity, and price transparency issues. However, the coupon payments can partly compensate for taking on these risks, and CIO has developed selection techniques that would allow investors to incorporate reverse convertibles into a well-diversified portfolio.

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Attractive: We consider this asset class to be attractive. Consider opportunities in this asset class.
Neutral: We do not expect outsized returns or losses. Hold longer-term exposure.
Unattractive: We consider this asset class to be unattractive. Consider alternative opportunities
Note: For equities, we have a five-tier rating system with two additional preferences
Most Attractive: We consider this asset class to be among the most attractive. Investors should seek opportunities to add exposure.
Least Attractive: We consider this asset class to be among the least attractive. Seek more favorable alternatives opportunities.
When equities are included with the other asset classes in the three-tier rating system, we collapse "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive."

Appendix

Risk Information
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