

Tech sell-off highlights need for diversification

Investment strategy insights

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- The sell-off across the software sector last week was severe, triggering a debate about AI disruption risk.
- Momentum reversals and increasing dispersion related to AI have impacted equity investors significantly. At the same time, market leadership is broadening beyond the US, offering new opportunities in other regions and sectors.
- While we maintain a positive outlook for US equities and anticipate further gains in the S&P 500, we downgrade the IT sector to Neutral. We believe diversification is essential for managing risks and supporting long-term returns. To capture a broadening market rally, we favor US financials, health care, utilities, and consumer discretionary sectors, and identify compelling opportunities in Asia and Europe.



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Market focus during the past week has centered on AI disruption risks. Software stocks have been at the center of that focus, with the MSCI Software and Services Index plunging by 4% over the past week (vs. 2.6% for the overall IT sector) and 16% since the beginning of the year (vs +4.5%). Across the market, stocks in data-intensive industries—including media, education, and business services—have also been caught in the sell-off, as have some asset managers. We expect volatility to persist in the coming weeks, as monetization will likely remain in focus and as investors weigh the impact of potential business model disruptions from AI.

Markets are increasingly differentiating between AI beneficiaries and laggards. After three years of strong AI rallies fueled by capex expansion, investors are now rewarding AI spending only when it comes with strong revenue growth. We have also highlighted that, as with past innovation cycles, companies that leverage new technologies to improve business outcomes are likely to see tangible financial benefits. With AI continuing to reshape industries, we think the latest sell-off is unlikely to be a one-off event. Firms that can successfully generate revenues

and profits from AI investment and adoption will likely be favored by investors.

Software valuation multiples have sharply fallen, although the analyst growth estimates embedded in those multiples remain elevated. The forward P/E multiple for software has declined from 35x in 2025 to 26x currently, representing the lowest absolute level since 2019 and the smallest premium to the average S&P 500 stock over the last 10 years. However, current profit margins and consensus revenue growth estimates stand at their highest levels in at least 20 years of data history. Implicitly, the decline in valuations indicates an expectation that these estimates will also decline.

The issue is not earnings today—but uncertainty around margins tomorrow. Analyst estimates remain stable, indicating that analysts see no immediate threat to corporate profits. However, there is growing uncertainty around future profit margins. Software and IT services firms currently enjoy very high margins, with the most significant increases seen over the past decade—making the sector more exposed to competitive pressures.

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Advances in AI are dramatically lowering the cost and time needed to develop software, which could lead to an exponential increase in available solutions. Although enterprises are unlikely to switch vendors quickly due to the complexity of existing systems, a flood of new offerings may intensify competition, resulting in downward pressure on prices and margins over time. If supply expands as expected, we believe that at least half of software companies could face substantial disruption risks within five years.

We are downgrading the information technology sector from Attractive to Neutral. Disruptions in the software industry, a sharp rise in capex spending that could absorb nearly all operational cash flow, and elevated hardware valuations may weigh on investor sentiment. We maintain Attractive views on other US sectors, including those with major tech companies such as communications services and consumer discretionary. We also retain our Attractive view on AI, noting that the AI opportunity extends beyond the S&P 500 IT sector.

Recent developments highlight productivity gains that extend beyond the tech sector. Just as past structural investments have boosted productivity, the latest advances add to growing evidence of AI-driven efficiency improvements. Last week, one major platform reported a 30% increase in output per engineer (and 80% for power users) since the start of 2025 thanks to the adoption of agentic coding, and management expects this productivity growth to accelerate. Regardless of how widely specific tools are adopted, the potential for productivity gains across areas should reassure investors about the long-term returns on AI investments.

Diversification remains essential in a volatile market. The S&P 500 Equal Weight Index has recently outperformed the traditional benchmark, signaling a broadening rally supported by a favorable macroeconomic backdrop. Gains in Asian and European markets also point to opportunities arising from regional fiscal expansion and structural reforms. In today's environment, where risks are higher and outcomes less predictable, we believe diversification across sectors and geographies is especially important.

So, while we remain positive on the outlook for US equities and expect the S&P 500 to move higher, we believe diversification is key to managing market risks and enhancing long-term returns. To position for a broadening rally, we like financials, health care, utilities, and consumer discretionary in the US, and see attractive opportunities across Asia and Europe.

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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

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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

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