



Melville Douglas Quarterly Commentary Global Equity Fund

/ Q2 2025

A difficult year

Having built a competitive track record over the past decade, it is disappointing to report the Melville Douglas Global Equity fund delivered weak index-relative performance over the past quarter and 12-months. This has taken some of the shine off the long-term numbers.

Stock selection lagged across the board. Notable weakness came within natural fishing grounds for quality compounders, namely healthcare (ICON, UnitedHealth, Thermo Fisher and Elevance were four of the five top detractors), consumer discretionary (LVMH), consumer staples (Estee Lauder and Nestle) and financials (not exposed to the sharp recovery in traditional European banks). Although there were specific reasons for why these names lagged, there were also broad disruptive shifts in their competitive backdrop and addressable markets that meant we were fighting against the tide.

Such dislocations provide opportunities for long-term investors as well as flag risks to mitigate. As a result, there have been more changes than usual to the Melville Douglas Global Equity fund over the past quarter.

One such opportunity is the technology sector, specifically artificial intelligence. The release of Chinese company Deepseek's highly efficient generative-AI model challenged prior US Big Tech hegemony. We however do not see this revelation as a zero-sum game, which was suggested by the market's initial negative reaction. Rather like the fall in the cost of mobile handsets in the 1990s, Deepseek-type solutions that lower the cost of utilising AI applications widen their scope and accelerates the adoption of use cases. It substantially lengthens the AI runway and increases a very large addressable market.

As such, we have increased the exposure to AI-related stocks by adding to the holding in AI-chip designer Nvidia at an attractive valuation entry point (as a result of the Deepseek-related sell-off) and by introducing Broadcom (designer of application specific AI chips) and Apple (gateway to AI apps) to the portfolio. We also continue to hold the three largest cloud service providers (Microsoft, Amazon and Alphabet) as well as AI infrastructure suppliers such as Amphenol and Taiwan Semiconductor. A common theme from businesses across geographies and industries is an ongoing (and even redoubled) commitment to AI-related capital expenditure to protect existential risks, save operating costs and open new market opportunities.



Another opportunity is Europe, where we have increased exposure. The region has long had a valuation discount (adjusted for sector mix) relative to the US, but there had previously been no catalyst. What has changed is increased scope and willingness for fiscal stimulus (particularly in Germany), European Central Bank monetary easing, the possibility of a Ukraine ceasefire, and potentially a more resilient earnings outlook (admittedly off a lower base relative to their US counterparts).

The risks to mitigate include the consumer and healthcare sectors. As such, we have lowered our exposure. Both sectors have previously been sizeable exposures in the strategy as brand power, innovation, patents and secular trends have resulted in wide economic moats and attractive growth prospects. However, there has been accelerated disruption over the past year.

Healthcare's long held safe-haven status has eroded with heightened policy and regulatory intervention from the Trump Administration which threatens business model profitability. The consumer will be squeezed by higher cost of living as a result of higher import duties and economic uncertainty relating to the Trump Administration policies. In addition, the power of old established multinational brands continues to wane as a result of increasingly robust local competition, geopolitics in a multipolar world, social media disruption and generational change.

We are sticking to our knitting. By its nature, i.e. outperformance requires a portfolio different from the benchmark, active portfolio management will exhibit periods of underperformance as a result of investment style shifts (e.g. growth to value) or when stock calls will not always pan out as forecasted (i.e. the only certainty is that the unexpected will happen). The key to achieving long-term results is to stay true to the underlying investment philosophy but being prepared to change one's mind when the facts change.





From our **Fund Manager's Desk**

Author: [Chris Willis](#) / Senior Analyst

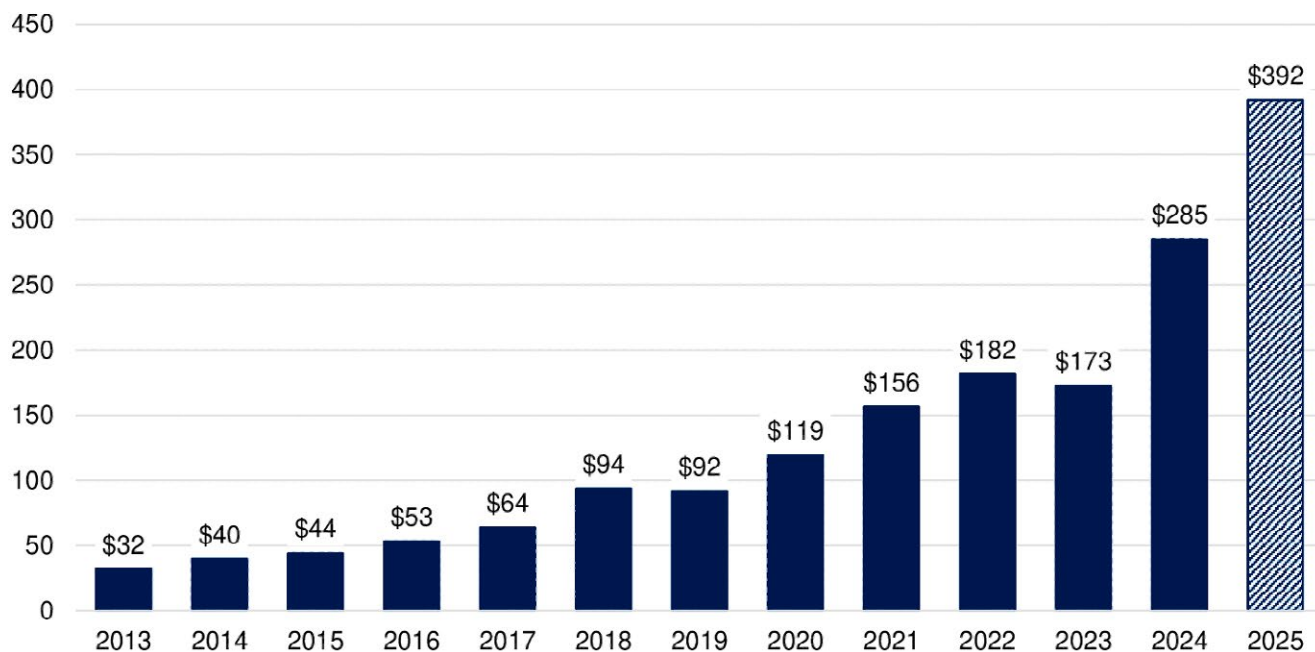
Waiting for GenAI's Godot: When will the profits arrive?

The promise of Generative AI (GenAI) has ignited a gold rush within the cloud computing sector, with giants like Microsoft, Amazon Web Services, and Google Cloud pouring hundreds of billions into AI development and infrastructure. Yet, a critical question lingers: when will the promised returns be realised on these outsized investments? Like characters in Samuel Beckett's 'Waiting for Godot,' cloud vendors and investors find themselves in a state of perpetual anticipation, grappling with the complexities of monetising a technology that, while transformative, presents a unique set of financial challenges.

The infrastructure investment surge

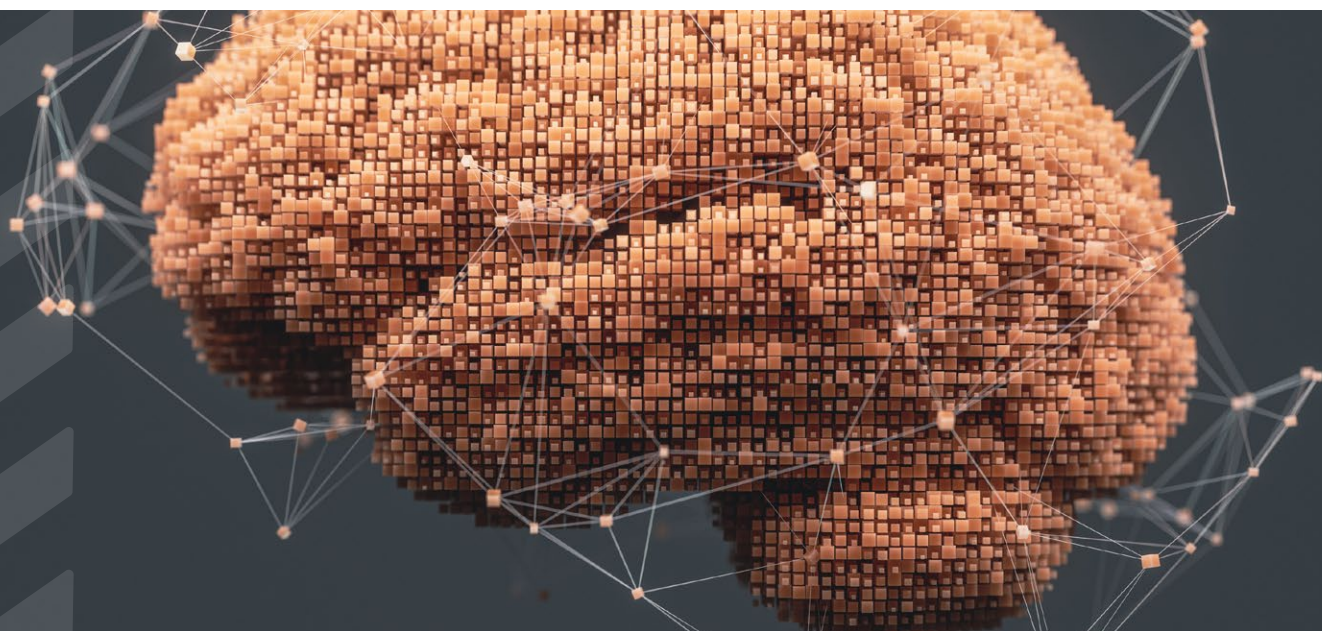
The sheer scale and pace of infrastructure investment is a primary driver of the delayed Return on Investment (ROI). The demand for powerful chips and specialised hardware to train and run large language models (LLMs) has led to an unprecedented build-out in data centres. According to Morgan Stanley research, the top 11 cloud players are expected to spend \$392bn on capital expenditure (capex) in 2025, an increase of almost 10% from their previous estimate, and roughly equivalent to total cloud capex in 2023 and 2024 combined.

CUMULATIVE CLOUD CAPEX (\$ BILLIONS)



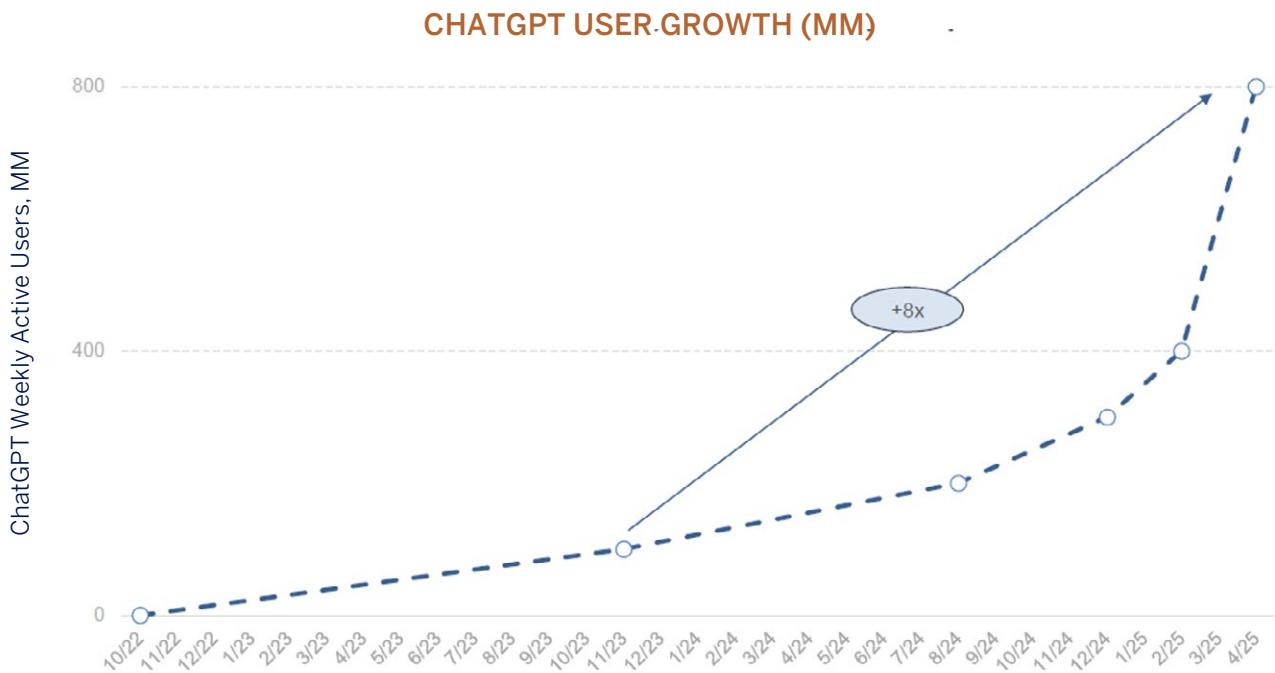
Source: FactSet, Morgan Stanley Research

This infrastructure build-out, requiring a substantial redesign of the traditional data centre and massive upfront investment, does not yield immediate returns. As fast as companies can begin selling services on their cloud platforms, they are building even more capacity with individual AI chip clusters bigger than the last. This constant cycle of spending and reinvestment means that any realised profits are soon diluted by new investments which take time to fine-tune and optimise.



Challenges of Monetisation

While GenAI offers a plethora of potential applications, convincing customers of its value has proven more difficult. OpenAI, which owns ChatGPT, has reported eye-popping growth. Currently, they have more than 800 million users and a target of one billion by the end of this year, a milestone it should reach faster than any application or platform has ever achieved.



Source: OpenAI, BondCap

The challenge for OpenAI has been converting its users into paying customers. While traffic through ChatGPT exploded, the number of paying subscribers has lagged. Estimates suggest that OpenAI has approximately 20 million paying subscribers and more than 3 million business subscribers. Those users have assisted OpenAI to grow annual recurring revenue to more than \$10bn - nearly double what it was at the end of 2024. Anthropic, a competitor offering its Claude AI range of LLMs, has seen annual revenue grow to \$3bn. While growing impressively, it is not enough to cover the cost of serving the hundreds of millions of free users and to continue developing cutting-edge AI. These companies remain dependent on funding from venture capitalists and investors to keep up with their growth ambitions.





The high-stakes gamble on AI

While the appeal and demand for GenAI is clear, we sit at an uneasy period of matching supply and demand. In any industry, over-investment can lead to excess supply, limiting future returns and even resulting in protracted losses for companies. The burning question every investor is asking is: are we witnessing a repeat of mistakes we've seen countless times before?

Real-world implementation of GenAI is still in its very early phases; most companies have only begun to experiment with its implementation. Consumer use cases are available but, as evidenced by the unwillingness to upgrade to paid subscriptions, they haven't quite found product-market fit. If we are still so early in this journey, then why are the cloud hyperscalers committing such massive amounts of shareholder capital to a future they cannot be certain about? The answer lies in what is called Agentic AI.

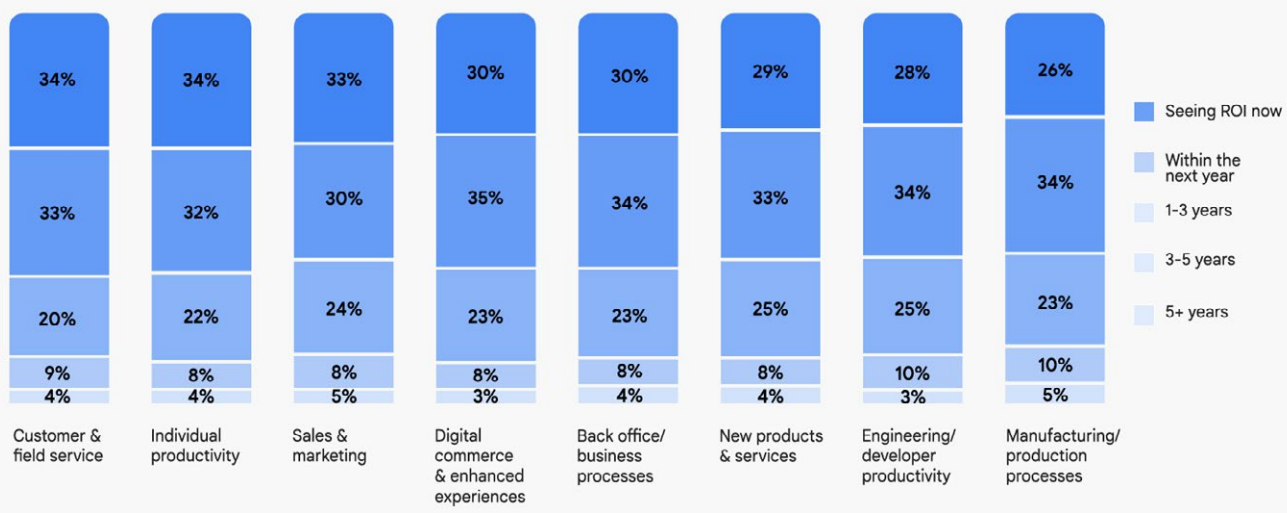
Agentic AI promises the development of autonomous AI software agents capable of perceiving, planning, and executing complex tasks. This pursuit is not merely a technological curiosity; it represents a paradigm shift towards AI that can operate independently, driving significant efficiency gains and potentially unlocking new business models. Every major tech company, from Google with its Gemini agents to Microsoft's Copilot extensions, is racing to develop these agents due to their potential to drastically automate workflows and enhance user experiences. Companies like ServiceNow are already deploying AI agents in customer service to handle routine inquiries and resolve issues, freeing up human agents for more complex tasks.

In the future, these agents could manage entire projects, autonomously negotiate contracts, or even conduct scientific research. The potential to create systems that react to the world and make decisions without constant human direction and interaction is the driving force behind this investment push by the largest global tech companies. The promise of these agents is the potential to drastically reduce labour costs and increase the speed of innovation.

The ROI of GenAI

Even while it is still early, there are tangible signs of how GenAI is profoundly impacting early adopters. In a 2024 Google Cloud survey of 2,500 senior business executives, 60% of respondents reported actively leveraging GenAI in production. Among those, 74% report having achieved ROI in at least one use case within the first year.

ROI TIMELINE FOR GEN AI USE CASES

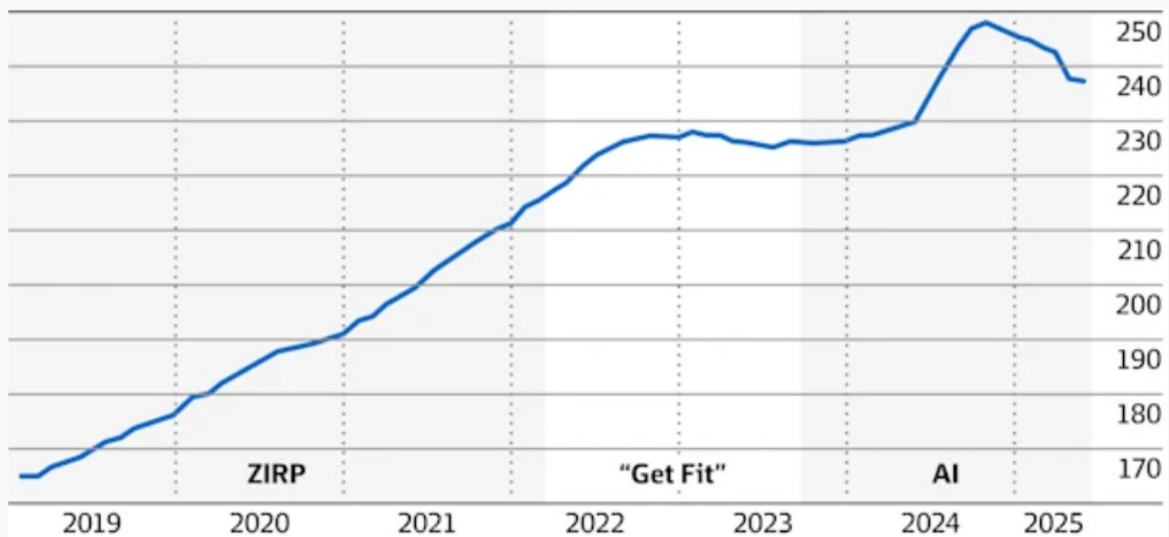


Source: Google Cloud

Unsurprisingly, given one of GenAI's best capabilities is writing computer code, we've seen it flourish in the IT sector. According to Deloitte's quarterly State of GenAI Report, IT departments are the most advanced in adopting GenAI. Here, software programmers are using AI to assist them in their day-to-day, to produce reams of code faster than before. Alphabet has previously said more than 25% of code was being written by GenAI. In May, Mark Zuckerberg said that he hopes that half the code development at Meta Platforms is going to be done by AI in the next year.

These big tech firms are achieving something remarkable - cutting staff, while continuing to grow. For these companies, where software development teams make up the largest expense, we could be entering a golden era of profitability.

MICROSOFT NUMBER OF EMPLOYEES ('000)



Source: Coatue



The evolving landscape and beyond

The GenAI landscape is constantly evolving, with new models and applications emerging at a rapid pace. The development of smaller, more efficient LLMs could help to reduce infrastructure costs and broaden accessibility. Additionally, advancements in AI agents and automation could unlock new revenue streams by enabling businesses to automate complex tasks and processes. Looking forward, the key to unlocking GenAI's ROI will be a combination of technological innovation and a focus on delivering value to customers.

The wait for GenAI's definitive ROI may feel like an endless loop, akin to the characters' vigil in 'Waiting for Godot.' However, beneath the surface of delayed returns lies a foundation of transformative potential. While the path to profitability may be uncertain, the long-term impact of GenAI on the cloud computing landscape is undeniable. As technology evolves and adoption accelerates, cloud vendors that can innovate and creatively solve customers' pain points will ultimately reap the rewards of this revolutionary technology. The key is to remember that while the perfect ROI may be elusive, the journey itself is reshaping the future of cloud computing.



Market outlook



I don't want people to know exactly what I'm doing – or thinking.
I like being unpredictable

Donald Trump writes about his political strategy in Crippled America (2015)

It has been an auspicious, uncomfortable but ultimately rewarding first half of the year with global stock markets initially rallying +6% from New Year to early February, plunging to a -16% nadir in early April amidst egregious US tariff policy, recession worries and Chinese AI competition, and then soaring +24% as President Trump backtracked and as Big Tech companies reassured on profitability.

Where to now?

The (intentional?) uncertainty and higher costs associated with the Trump Administration's erratic trade policy has impacted business and consumer sentiment, which is filtering through to lowered corporate earnings projections. The last quarterly reporting season saw numerous companies cut or change guidance blaming tariff uncertainty. To name a few across a range of industries...Procter & Gamble, Tesla, Volvo, Merck, PepsiCo, Chipotle, Walmart, Delta Airlines, Thermo Fisher, Tractor Supply, Kimberly Clark, and Electrolux.

At the start of the year, consensus earnings growth forecasts for the MSCI All Countries World index was +12% for the calendar year 2025. It is now +7%, i.e. almost half the original estimate reflecting this management cautiousness. Nonetheless, consensus forecasts arguably have some conservatism baked in, especially as the 8% decline in the US dollar index provides an offsetting positive translation effect for US listed multinationals stocks with overseas earnings. In short, there is still sufficient profit growth to drive markets.

But what about valuation, particularly in the US?

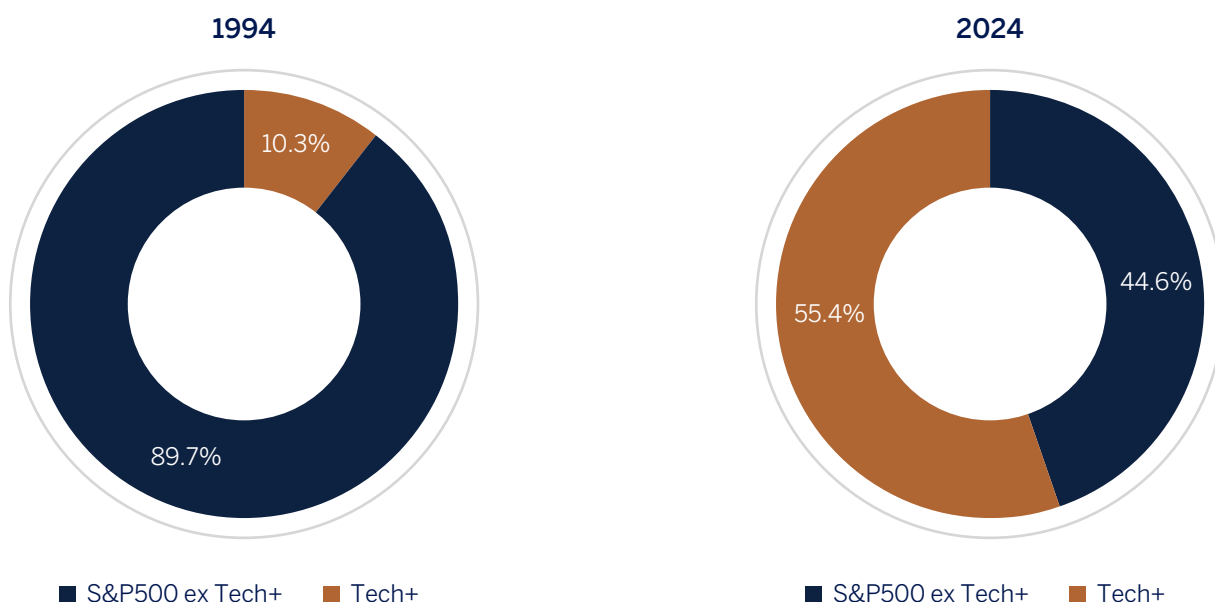
The chart below shows the S&P 500 index is trading near the upper end of its 20-year history and at a premium to European large capitalisation stocks (Stoxx 50 index). Hence, there is a case to be made that the market is overpriced.

AT A GLANCE, THE US LOOKS EXPENSIVE RELATIVE TO HISTORY AND RELATIVE TO EUROPE



However, a cursory view does not account for the broad shift in the US market over the past 30 years from around 10% in “Tech+” (i.e. broadly defined technology companies, including not only hardware and software but also social media, ecommerce and the likes of Tesla and Netflix). The index shift to these highly free cash flow generative businesses arguably demands a higher valuation.

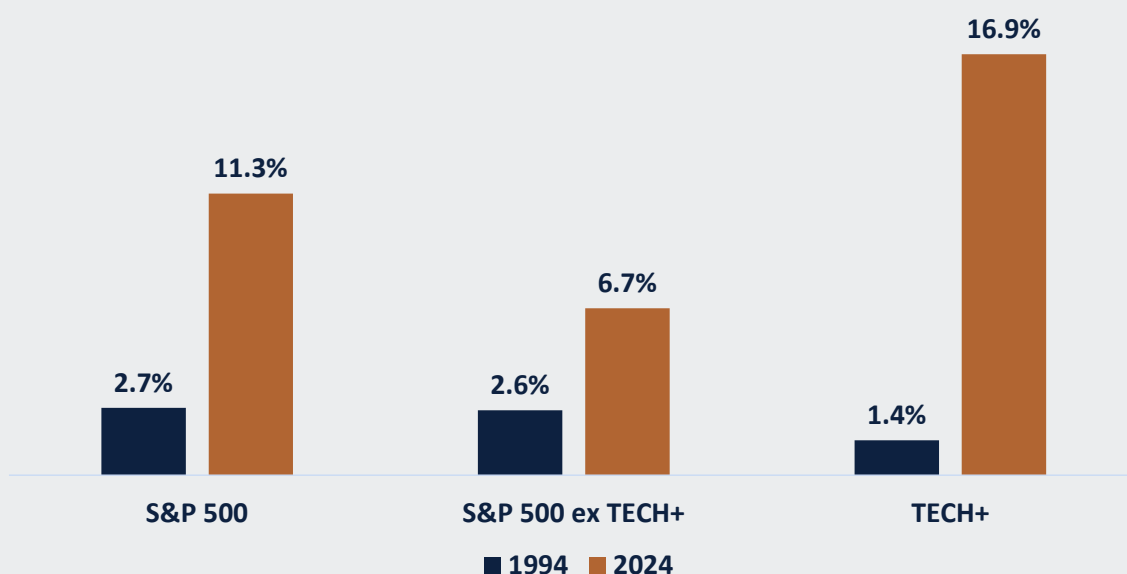
PAYING UP FOR QUALITY – THE CHANGING FACE OF THE S&P 500 OVER THE PAST 30 YEARS...



Source: UBS

...WHICH IS MORE CASH FLOW GENERATIVE

Free cash flow as % of sales

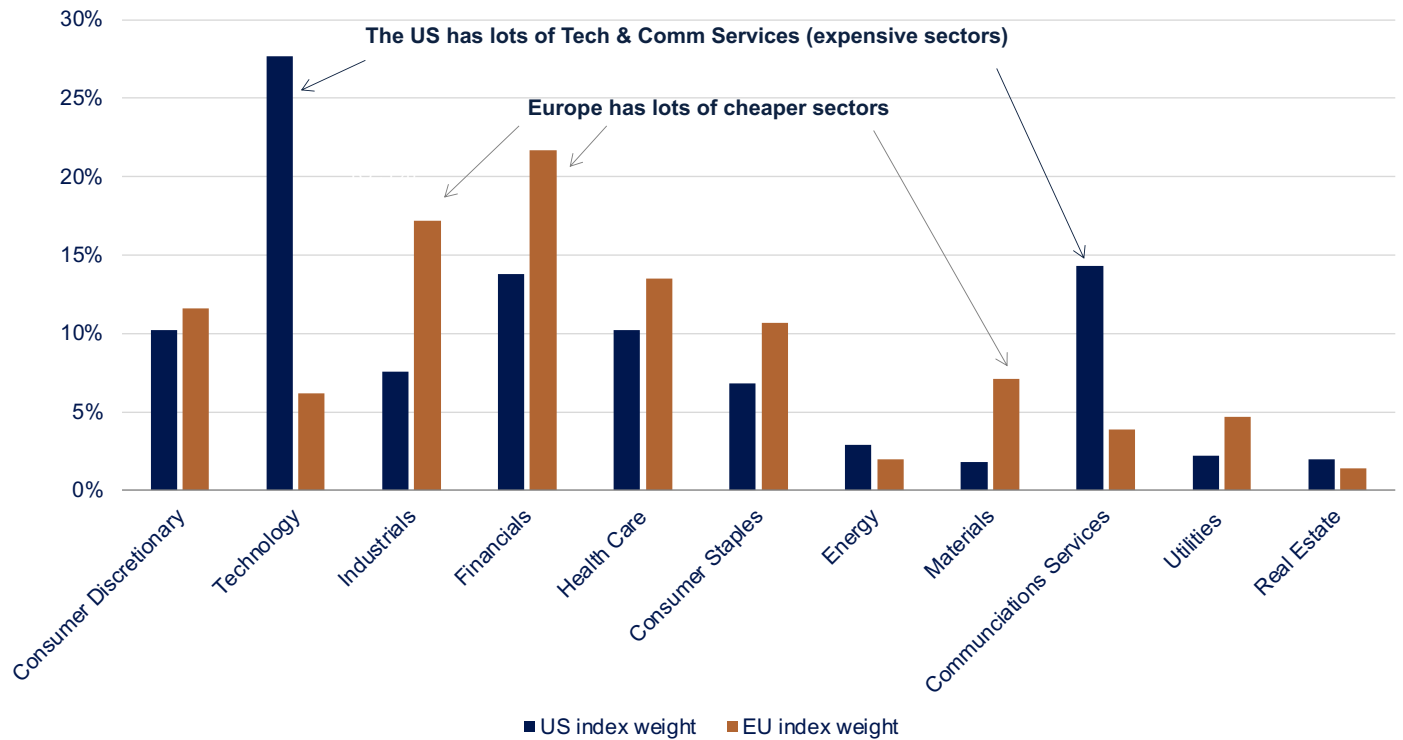


Source: UBS



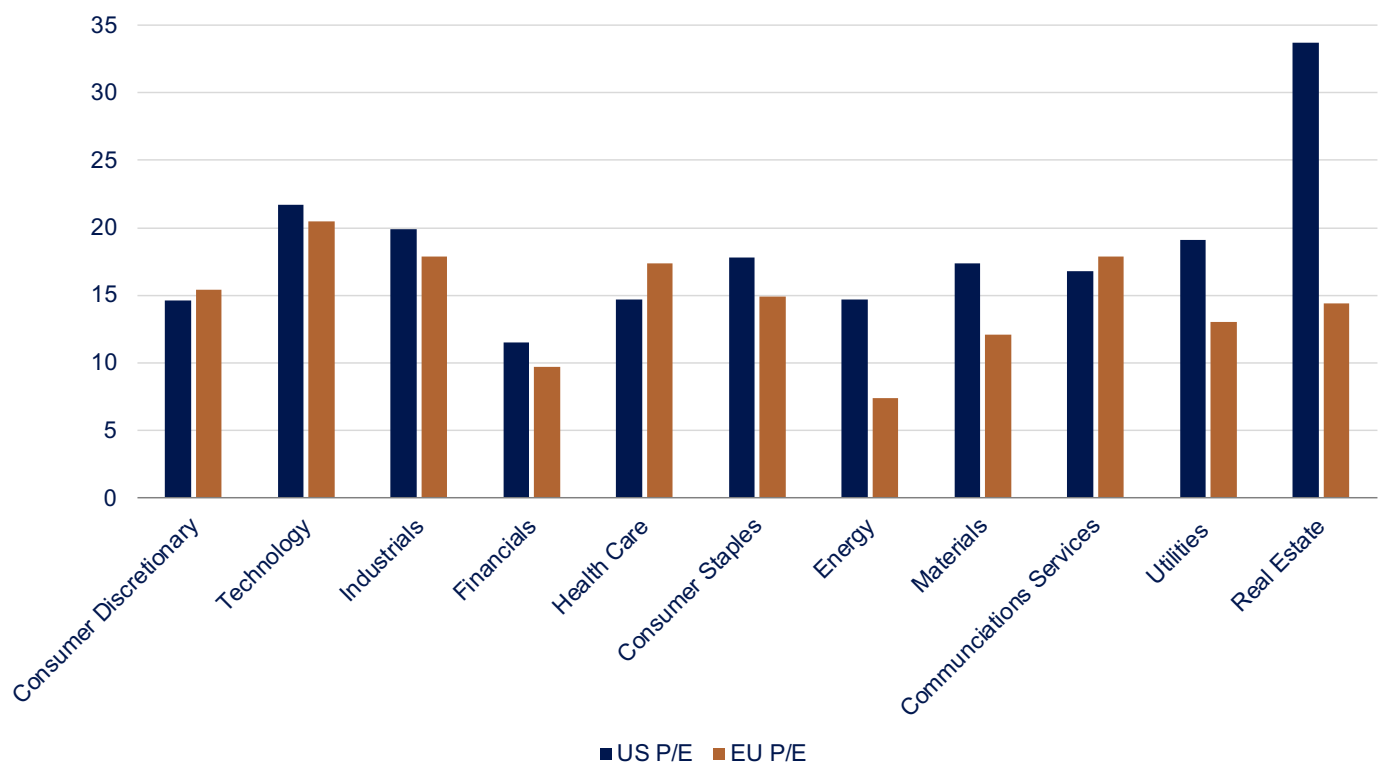
This also applies when making comparisons with other regional indices, such as Europe. As shown below, Europe has high weights to old economy financials and materials that should trade on lower P/E ratios to account for higher earnings risk and generally mature growth prospects.

INDUSTRY SECTOR WEIGHTS IN THE US AND EUROPE EQUITY INDICES



Robert Baird, Bloomberg

US VERSUS EUROPE MEDIAN PRICE-TO-EARNINGS RATIO BY INDUSTRY SECTOR



Robert Robert Baird

If the US sector P/E ratios were weighted according to the Europe index, the US would be trading on 16x (as opposed to 18x when the analysis was carried out at the lows of mid-April). This is only a slight premium relative to Europe on 15x.

In short, there is a building diversification case for lowering some US equity exposure in the portfolio in favour of some Europe and China exposure given comparably better government/monetary policy support and improving corporate earnings growth. But, despite President Trump's best efforts to dissuade foreign investors by keeping them guessing, there is also a compelling case for continuing to own US companies over the long-term as the country remains home to many (if not the majority) of the world's best quality-growth compounders.



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