




From our **Fund Manager's Desk**

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A fresh perspective on moats and disruption

Quality investing for the Melville Douglas Global Equity Fund has always been defined by seeking out companies with sustainable competitive advantages. These advantages allow a business to compound value over time, earning superior returns by raising prices, gaining market share, or both. The presence of such an advantage, often referred to as an economic moat, is one of the most reliable indicators of long-term shareholder returns.

Companies without a moat tend to face intense competition and the constant threat of product substitution. By contrast, those with wide and durable moats can enjoy decades of uninterrupted profitability. However, in the age of artificial intelligence, much of what we thought we knew about moats has come into question.



With intelligence becoming increasingly abundant and powerful, AI has the potential to disrupt established industries and, in some cases, render entire products or services obsolete. The companies most at risk appear to be those with digital products, where competitors may use AI to replicate offerings more easily, or where customers may simply no longer need a particular service.

Over the past twelve months, equity markets have been quick to reflect this uncertainty. Investors have shunned many asset-light business models and instead favoured so-called “old economy” companies with physical assets and operations that appear less exposed to AI disruption. This quarter, we explore this shift and share insights from ongoing discussions within the Melville Douglas Global Equity team.



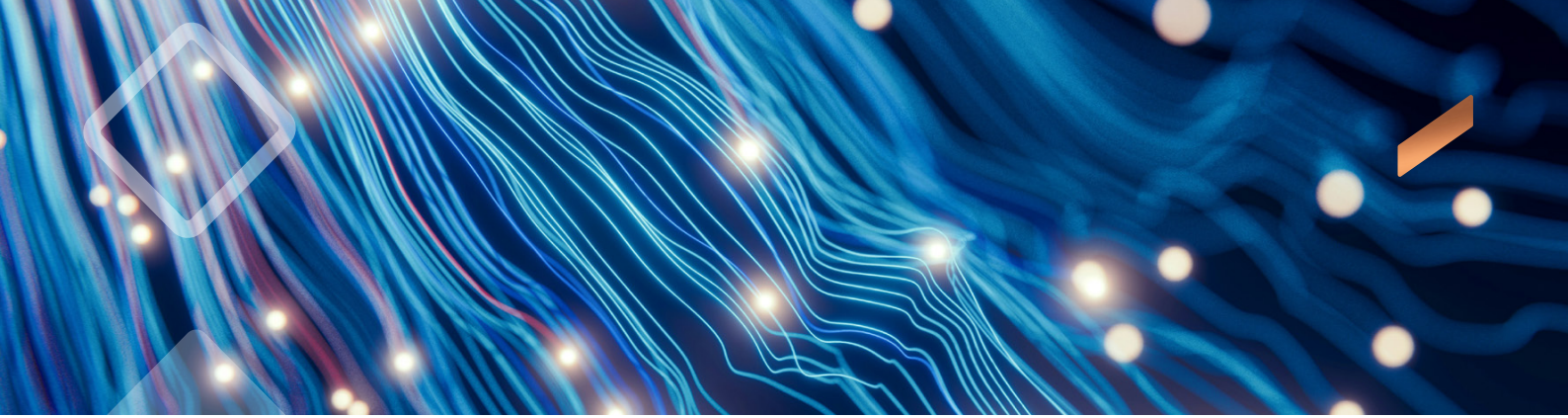
Rethinking economic moats in the age of AI

Identifying and understanding economic moats has always been a hazardous exercise. Many companies appear to enjoy strong advantages, only for these to fade over time as competitors find ways to undercut them. Assessing the sustainability of a moat is the true challenge and the rise of AI has made this task harder than ever.

Historically, we have assessed moats through a small number of broad archetypes. The most durable tend to be built around strong brands, network effects, and high switching costs. While generative AI is undoubtedly acting as a technological shortcut for replicating certain products, we believe many traditional moats remain intact.

Consider global payment networks such as Visa and Mastercard. Their enormous two-sided networks, with billions of consumers carrying their cards and more than 100 million merchants accepting them, remain largely unaffected by AI. This scale allows them to process trillions of dollars of transactions at a marginal cost that AI-enabled competitors simply cannot match.

This vast network of users, like those of many companies we own, creates a virtuous circle: as the network grows, the service becomes more valuable to both consumers and merchants. Crucially, the cost of operating and expanding the network does not increase at the same rate, giving Visa and Mastercard a significant and enduring cost advantage over would-be competitors.



Similarly, credit rating agencies such as Standard & Poor's appear to be strengthening their moats. While AI can provide rapid analysis of financial statements, it cannot offer judgement, nor does it carry the authority of a trusted rating agency. These institutions are embedded within the global financial system, supported by decades of institutional memory and regulatory acceptance. For many users, that trust outweighs any potential cost savings offered by an unproven AI alternative. The Standard & Poor's brand represents that trust.

This is why, in the heavily regulated banking industry, credit scoring frameworks are built on top of credit ratings from the agencies and approved for use by central banks and regulators. An untested AI-driven credit scoring tool, without regulatory endorsement or a proven track record, cannot simply replace this role. Instead, it is far more likely that incumbent institutions, both banks and ratings agencies, will adopt AI to enhance their existing models and processes, strengthening their tools rather than being displaced by them.

AI as both threat and enhancer

While uncertainty has increased around some competitive advantages, we do not believe AI is a universal moat destroyer. Many of the companies we consider investable benefit from multiple overlapping moats, and AI is unlikely to erode all of them. In some cases, incumbents may even strengthen their position by deploying AI themselves.

Microsoft is a good example. The company operates across nearly every layer of the technology stack from data centre infrastructure and enterprise software to operating systems and productivity tools used by much of the global workforce. Microsoft benefits from both high switching costs and powerful network effects, neither of which we believe are threatened by AI. On the contrary, its central role in the enterprise ecosystem positions it well to become the orchestration layer through which many organisations may access and deploy AI.

The market's reaction and our perspective

While markets have questioned the future profitability of many digital businesses, they have rewarded more traditional, asset-heavy industries that we would typically find less attractive.

Although we understand why investors have gravitated towards these sectors in the short term, we believe rewarding them with higher valuations is unwise. While they may appear less exposed to AI-related uncertainty over the next few years, the underlying competitive dynamics of these industries remain unchanged.

The recent rally in the telecommunications sector illustrates this point. Lower capital expenditure has boosted short-term cash flows, but structurally these businesses continue to suffer from weak customer loyalty and regulatory frameworks designed to increase competition and suppress returns. Recent improvements reflect a cyclical reprieve rather than a lasting structural shift.

Utilities, particularly in Europe and North America, have benefitted from higher power prices as demand from AI data centres has surged. While compelling in the near term, we do not believe this represents a new source of durable competitive advantage. Over time, excess profits will attract competition bringing additional power online and returns are likely to drift back towards historical norms.



Investing under uncertainty

What we are forced to confront is that AI has introduced new competitive threats across almost all industries. Some companies we own today may face risks in the future that are difficult to foresee. We categorise this uncertainty in the following manner.

Known Knowns	Measurable Risk
Known Unknowns	Certain Probability, Uncertain Outcomes
Unknown Knowns	Uncertain Probability, Certain Outcomes
Unknown Unknowns	Uncertain Outcomes & Probabilities



To address this, we use a framework that helps distinguish different types of uncertainty:

- / Risk:** Outcomes are known and probabilities can be reliably, albeit approximately estimated.
- / Uncertainty:** Either outcomes or probabilities are unclear.
- / Ignorance:** Both the possible future outcomes and their probabilities are unknown.

An increasing number of investment decisions now fall into this final category. The speed and breadth of AI disruption may exceed our expectations, and companies with strong moats today could find themselves displaced by entirely new business models, or by customers unable to adapt.

In response, our guiding principle remains unchanged: to own high-quality companies where the odds are likely in our favour. Businesses with high and stable profitability, strong balance sheets, disciplined capital allocation, and capable management teams are more likely to endure, even in the face of profound uncertainty.

Provided there is sufficient margin of safety, we believe it is still possible to invest confidently even when facing the unknown unknowns.

Final thoughts

As fundamental investors, we recognise that quality investing has evolved, and so too have the tools we use and the lens through which we judge the companies we would like to own.

In an era of abundant intelligence, true quality lies in what cannot be easily replicated.





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