

Software Stocks, AI Disruption, and the Importance of Diversification

Services

Investment Management

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The software industry has declined nearly -30% from its peak last October, one of the largest non-recessionary drawdowns in over 30 years. Figure 1 puts the decline in historical context alongside the other major software selloffs. The two largest drawdowns before the current one, the dot-com bust and the 2008 financial crisis, both occurred during recessions, when corporate earnings were declining and businesses were cutting spending. The 2022 selloff, driven by the Federal Reserve's aggressive rate-hiking cycle, was the first major non-recessionary decline and saw software stocks fall nearly -40%. The current drawdown, at nearly -30%, surpasses the COVID pandemic, but it's driven by a fundamentally different catalyst: artificial intelligence.

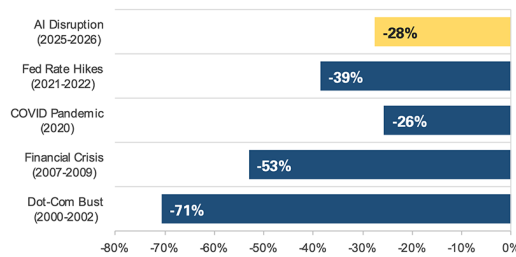
The sell-off accelerated in January and February after a series of artificial intelligence (AI) product launches showed that general-purpose AI tools could perform tasks previously handled by specialized software at a lower cost. The market's reaction was swift and sequential. Software stocks fell first, but concerns quickly spread to other industries, including financial data providers, commercial real estate services, and logistics companies. The sell-off reflected a shift in how investors view AI. For the past two years, AI has been seen as a productivity tool that would help existing companies do more with less. The January and February product launches crossed a threshold: investors started pricing AI as a potential replacement for entire categories of professional services, not just a tool to make companies more efficient.

By late February, the narrative around AI disruption began to cool and markets started to stabilize. Wall Street analysts pushed back on the worst-case scenarios, and the conversation shifted from AI would replace entire industries to a more focused debate about which industries are genuinely vulnerable and which will find ways to adapt and develop potential competitive advantages. Several of the hardest-hit stocks rebounded, and while the software industry partially recovered, it remains down more than -25%. The broader question of how AI will reshape professional services and the enterprise software industry is far from resolved, and its effects may continue to surface across the market as AI tools evolve.

The software industry's sell-off is a reminder that even well-established businesses can experience rapid repricing when the market's assumptions about future earnings change. However, Figure 2 shows the direct impact has been limited for diversified investors.

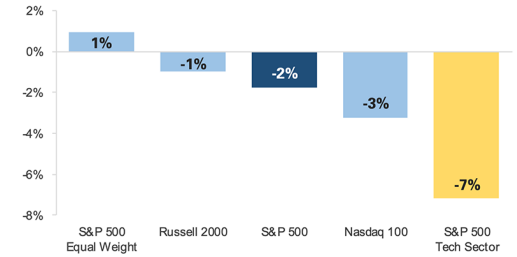
International stocks and the average S&P 500 stock have both produced gains, while small-cap stocks, the broader S&P 500, and the Nasdaq 100 are each down low single digits. Our takeaway: portfolio diversification across sectors and asset classes remains an effective way to manage the uncertainty that comes with rapidly changing environments and market volatility.

Figure 1 – Software Industry Drawdowns Over the Last 30 Years



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Figure 2 – Performance During Current Software Drawdown



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The S&P 500 Index or Standard & Poor's 500 Index is a market-capitalization-weighted index of 500 leading publicly traded companies in the U.S.

The Russell 2000 index measures the performance of approximately 2,000 small-cap US equities.

The MSCI EAFE Index is a stock market index that measures the performance of large- and mid-cap companies across 21 developed markets countries around the world. Canada and the USA are not included.

The MSCI Emerging Markets Index captures large and mid cap representation across 24 Emerging Markets (EM) countries.

The Nasdaq 100 Index is a stock index of the 100 largest companies by modified market capitalization trading on Nasdaq exchanges.

The Russell 1000 Growth index is an index that tracks large cap, growth stocks. This benchmark is important for investors that might tilt their investments towards large cap growth. Growth stocks, in comparison to value stocks, are considered companies with a more growth potential, and a higher risk profile.

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business model.

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The Bloomberg US Corporate Index covers performance for United States corporate bonds. This index serves as an important benchmark for portfolios that include exposure to investment grade corporate bonds.

The Bloomberg US Corporate High Yield Index covers performance for United States high yield corporate bonds. This index serves as an important benchmark for portfolios that include exposure to riskier corporate bonds that might not necessarily be investment grade.

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