Confluent Lets Users Pair AI with Real-Time Data Access

ADAM XIAO, CFA, joined Kayne Anderson Rudnick Investment Management, LLC in 2018. He is the Portfolio Manager of KAR's Thematic Quality strategy, and as a Senior Research Analyst covers the small-cap and mid-cap financials, consumer discretionary, information technology, and industrials sectors. Mr. Xiao previously worked as an Equity Research Senior Associate at Diamond Hill Capital Management and as an Equity Research Associate at Dodge & Cox. He received a B.A. in Operations Research and Management Science from the University of California, Berkeley, and an MBA from Columbia Business School, and is a CFA charterholder.

SECTOR — GENERAL INVESTING

TWST: Tell us about the new investment strategy that KAR has launched called Thematic Quality. What's the broad investment thesis?

Mr. Xiao: There are two parts to it — the quality investment philosophy, which is shared across Kayne Anderson Rudnick's investment strategies, and then the thematic overlay.

Starting with quality, as a firm we view quality to mean differentiated businesses with enduring competitive protections, favorable long-term prospects, and robust economic characteristics.

To elaborate on that in my own words, in capitalism, being sustainably different in a way that customers value often results in more consistent profit growth over the long term. If a business is different in a way that customers value, then that business can have pricing power. With pricing power, that business can achieve high returns on invested capital and compounded earnings growth.

The sustainability of differentiation is the key input for achieving this compounding over the long term, and this requires a company to have competitive protections that can endure over time against the onslaught of motivated competitors who want a slice of that pie.

There are various types of competitive protections, including switching costs, scale advantages, network effects, brand loyalty, and a few others. Our research work as a firm is focused on verifying the strength of competitive protections an individual business might possess.

TWST: And what do you mean by "thematic"? Could you give us a few general examples of themes? What I imagine are industry shifts or areas of opportunity that you are seeing.

Mr. Xiao: With themes, I'm defining it specifically for the strategy. When I speak about themes, it's a framework for recognizing that there are structural changes to our economy that frequently happen at an accelerated pace. These changes can be because of technology, demographics, or global issues. And what these changes do is either create entirely new industries or reshape the market share of existing industries through the introduction of better-fit products or services.

In both these cases, I believe there are opportunities for up-and-coming businesses to become the new industry leaders. The idea is to benefit from long-term forcing functions, like the internet resulting in more informed consumers, businesses' increased need to defend against cyberattacks, and new technological advancements such as AI.

TWST: Walk us through your research and investment and company analysis process.

Mr. Xiao: Our process as a team is to seek out, across the investment universe, the highest-quality businesses that we can identify through our fundamental bottom-up research process. With this organizing principle, it helps filter out potential distractions. Examples of these distractions are companies without a differentiation that can be articulated by an informed observer, companies with economics primarily tied to commodity prices, and companies with boom-and-bust histories.

By contrast, we're looking for competitively protected companies that can make sustained progress throughout a complete business cycle. This includes reading company documents, meeting with management teams, attending conferences, and speaking with industry participants.

Through this process, we get a greater understanding of industry structures, tailwinds or headwinds, and the market positions of individual businesses within each industry.

TWST: Number of holdings, position size, turnover, holding period — what are the important elements of how you approach portfolio construction for the Thematic Quality strategy?

Mr. Xiao: We manage high conviction, concentrated portfolios with low turnover and long holding periods. This is driven by our experience that high quality is rare. When you identify a great

business that you understand, you want to hold on to that business and not dilute that ownership by trading down in quality or your own understanding of the holding.

Specific to Thematic Quality, it's an all-capitalization strategy. It owns 20 to 35 stocks. The maximum weight is 7.5% on purchase, and it can hold a position up to 15% of the portfolio as that position grows.

TWST: Are you able to tell us about a few specific holdings?

Mr. Xiao: Yes, I'd be happy to, and one thing you asked earlier that I would like to more fully address is some of the attractive themes today.

One theme that is on the minds of a lot of investors and companies is the generative AI theme. In my view, artificial intelligence is a very important technology. Today, most of the spending is on semiconductors, the hardware, and the data center groundwork to deliver more performance and higher-volume generative AI capabilities.

The major monetizable end-user use cases have yet to be determined. Estimates are that industry capital expenditure spent for generative AI is in the hundreds of billions, while actual generative AI end-product revenues are in the single-digit billions.

The leading technology standard for real-time data streaming with an open-source technology is called Apache Kafka. This technology is estimated to be utilized by over 70% of the Fortune 500. The technologists who created Apache Kafka founded a company called Confluent to create a managed service underpinned by Kafka that provides better security, total cost, and governance than open-source Kafka.

The example I provided earlier of a large language model travel agent is not hypothetical. This conversational travel agent is something that Expedia (NASDAQ:EXPE) has already enabled in Expedia's app, powered by ChatGPT as the LLM and using Confluent's data pipelines to connect ChatGPT with all the real-time flight booking systems and separate hotel booking systems.

My view is that businesses have only scratched the surface of what can be achieved with generative AI paired with real-time data access. I view Confluent as well-poised to benefit as these real-time AI applications roll out, due to Kafka's industry standard positioning, real-time data pipelines, and Confluent's scale technology investments in making Kafka better performing and more cost effective as a managed service.

"The technologists who created Apache Kafka founded a company called Confluent to create a managed service underpinned by Kafka that provides better security, total cost, and governance than open-source Kafka."

Usually for a business, capex expense is a percentage of sales, and not vice versa, where sales are a percentage of capex. So, from my perspective, for the AI business model to be sustainable, end-product revenues would have to grow to become multiples of the amount of dollars spent on GPU capital expenditures today.

That is why I believe there's another leg of growth that could eventually come from the total generative AI industry that could dwarf the growth seen this year, just in its nascent stage.

Therefore, we see opportunities today in the important enabling technologies that have more recurring type revenues and strong opportunities to be a lasting part of the AI stack. These, in my view, are attractive approaches to invest in the future usage of generative AI and include vendors at the edge of computing and the data management layer.

As an example, I'd like to describe Confluent (NASDAQ:CFLT). For context, while highly performing general purpose large language models — LLM — training on broadly available internet data can suffice for a large swath of queries out there, one area that requires supplementation is business-specific queries on a company's internal proprietary data.

The technique developed for achieving this is known as retrieval-augmented generation — RAG — where LLM retrieves data from resources external to the LLM's trained knowledge base. This can be particularly valuable for applications where facts change in real time.

An illustrative example would be a generative AI travel agent who needs to access what flights and hotels are available and at what prices while booking a customer's travel plans. This requires accessing multiple technology systems in real time.

TWST: Are there any other themes and examples you'd like to mention?

Mr. Xiao: I do want to touch on some non-technology examples, but first, one important continuing technology example is Tesla (NASDAQ:TSLA), which is currently in the "future mobility" theme. While many end-product artificial intelligence leaders have yet to be determined, I feel like this is an important exception that is worth discussing.

Tesla is the leader in miles-collected data for self-driving vehicles. One comparison is Waymo, the autonomous driving technology company, which has over 20 million miles driven. By contrast, Tesla has over 1.2 billion miles of self-driving data.

I believe the key difference is in the business model of Tesla versus other self-driving technology vendors, such as Waymo, regarding data collection.

Customers pay Tesla to buy their cars and subscribe to FSD Beta. Other self-driving technology vendors must first pay test drivers, and then offer limited autonomous taxi rides supervised by remote paid employees, who must intervene when needed. Meanwhile, Tesla does not have to pay the FSD Beta subscribers to intervene, while also collecting the data from intervention, and training on this much larger data set.

Neural networks, the underlying mechanism behind all types of AI, rely on having access to real world data to train on. Having a larger data set from real world driving captures edge cases, like a plastic bag in the road that looks like a rock, or reflections that would confuse visual sensors.

From my perspective, Tesla has the strongest dataset and will continue to extend their lead over time.

In my view, Tesla doesn't have to achieve full autonomy to realize software margins on self-driving, it only requires further adoption of the subscription across the driver base. Tesla's software has notable unit economics because building software once and selling it multiple times is far better than building cars, which has gross margins in the 20s. Software businesses, on the other hand, have gross margins in the 70s or greater.

They are also using the same vision-based AI system to train their robotics, which may provide greater optionality and much larger revenue opportunities than self-driving vehicles, although it is still early days.

TWST: What non-technology example would you like to discuss?

Mr. Xiao: As I mentioned before, the internet has led to a more informed consumer. There is a theme that's labeled "consumer" within the portfolio that is primarily around shifting consumer preferences.

Mr. Xiao: It has to do with both sell discipline and valuation.

Regarding sell discipline, the primary reason for selling a position is if the business deteriorates. This can be due to changes in the competitive landscape or structural industry demand, or acquisition activity by management. Other reasons to sell would include a portfolio upgrade such as finding a higher-quality business.

We will also sell a position if valuation becomes too stretched. Valuation is a multifaceted analysis, beyond just growth and profit margins. We think that market participants under-evaluate a factor — persistence of earnings power — and that's where much of our work is being done.

How sustainable and durable are a company's earnings? This is determined both by its competitive protection, the strength of that over time, as well as how management is allocating the capital of the business.

> **"Tesla's software has notable unit economics because building software once and selling it multiple times is far better than building cars, which has gross margins in the 20s. Software businesses, on the other hand, have gross margins in the 70s or greater."**

As an example, Celsius (NASDAQ:CELH) is one of the holdings in the shifting consumer preferences theme — specifically, increased consumer awareness around the harm of sugar and the benefits of fitness, which have resulted in a new category of functional energy drinks distinct from the classic energy drink market.

Today's health-conscious consumer is seeking low sugar and functional ingredients that can boost their metabolism and increase workout effectiveness. New products have emerged with better credibility than more traditional energy drinks with sugar in this space.

The product category was first established by Bang Energy, which was later acquired and whose distribution agreements with two multinational beverage companies fell apart. This created an opening for Celsius to partner with each of these distributors over time.

There's only so much space in retailers' floor plans and in the trucks of distributors who service them. Retailers need to fill their shelves with a product that will turn the fastest, which creates opportunities for one to two leaders in new categories to emerge and retain their spot for the long term. This has held especially true for non-alcoholic caffeinated beverages, which have shown strong habitual brand loyalty historically. These products become part of a consumer's daily routine.

Historically, category leading beverage companies have enjoyed substantial pricing power and significant profitability, with sizable gross margins at maturity.

Demographically, Celsius consumers have an even 50-50 split between women and men and a broad age demographic. Data shows that 40% of new Celsius drinkers didn't drink energy drinks before drinking Celsius. Based on this data, I believe the continued opportunity for Celsius is considerable.

TWST: Great example. It's easy to forget there are other noteworthy industries and trends outside of technology these days. What characterizes your approach to risk management with this portfolio?

By having long holding periods and concentrated positions, we can spend the bulk of our work monitoring our holdings for changes in the business or when expectations are too high for the valuation of the business.

TWST: How will you benchmark the success of this strategy?

Mr. Xiao: The strategy's benchmark is the S&P 500. That said, the strategy moves independently of the index due to being concentrated in holdings that are differentiated from the holdings concentrated in the S&P 500.

The strategy should be expected to be more volatile than the index, due to the companies still being within their rapid expansion phase compared to the more mature, but also more saturated, mega-cap members of the S&P 500.

I believe the best approach to identifying the benefits of the Thematic Quality strategy is to look at the holdings from a long-term perspective. It can be a bumpy ride, markets remain unpredictable, and past performance is never a guarantee of future results, but I believe the best way to realize the potential benefit from the strategy is to view the strategy and its holdings over a complete business cycle.

TWST: Is there anything I didn't ask about that you would like to wrap up with?

Mr. Xiao: You didn't ask a question which I prepared for, which is regarding the macro outlook. Near-term macro is not something that we look at, and my answer was going to be around the longer-term, multi-decade macro factors that investors must always consider.

TWST: What are those multi-decade macro factors?

Mr. Xiao: The way that I look at macro is that there are a few constants that investors must always be aware of. One has always been inflation. There's been intense focus on it in recent years, given its position as a driver of Federal Reserve interest rate policy, but it's been a factor present for over a century. Over the last 30 years, the purchasing power of the dollar has more than halved.

With the presence of today's severe national debt and higher interest rates potentially increasing the deficit, it is uncertain whether higher interest rates can tame inflation. Bearing this in mind, I believe investors should consider assets that can preserve and grow their purchasing power over time, otherwise that purchasing power may be eroded by inflation.

As I alluded to above, this is why we emphasize owning quality businesses that have pricing power to raise prices above inflation over the business cycle and how we believe investors can protect their purchasing power over time.

One final observation on macroeconomic forces: There's been an unbelievable pace of change that we've observed during our lifetime. If you look at the span of human history, there were millennia that passed where children's lives were not much different than their parents'. In the last few centuries, there have been world-changing advancements, whether it was nitrogen fertilizers, penicillin, assembly lines, or computers.

I believe this is due to the force of stacking innovations, and previous innovations building on top of other innovations, each one enabling the next.

One quintessential example we can think of from our lifetimes is the internet, which has allowed for the expansion of global communication, international commerce, and the collaboration of knowledge. This has spurred countless improvements and subsequent innovations across innumerable fields, and the internet itself has relied on the advent of semiconductors, computation, networking technologies, and so much more.

TWST: Thank you. (MN)

ADAM XIAO, CFA
Portfolio Manager & Senior Research Analyst
Kayne Anderson Rudnick Investment Management, LLC
www.kayne.com
email: info@kayne.com