

Investment Perspectives

September 2025

Diversifying Away from AI Capex—the Case for KAR Thematic Quality

Today, the S&P 500 is increasingly concentrated in mega-cap technology stocks riding the AI data center spending boom, and investors face a growing risk of thematic overexposure. While this trend has fueled impressive index-level returns, it also raises questions about durability should AI-related capital expenditures decelerate. By contrast, the KAR Thematic Quality portfolio is less exposed to the AI capital expenditures (capex) cycle—instead focusing on resilient, long-term themes distinct from the index's current tilt. This differentiated positioning stems from KAR's focus on companies with three defining traits: (1) a preference for business models with recurring revenues, (2) exposure to long-term structural themes underrepresented in the index, and (3) ownership of businesses with idiosyncratic growth drivers. In today's market, we believe these characteristics may offer resilience and balance to portfolios increasingly tethered to a single macro engine.

The Problem

The S&P 500 remains a collection of high-quality businesses, but in 2025, we've seen a growing vulnerability emerge: a significant portion of index constituents are increasingly reliant on AI data center spending to drive revenues, earnings growth, and valuation multiples. This capital expenditure boom is fueling not only the financial results of semiconductor vendors supplying graphics processing units (GPUs), central processing units (CPUs), and networking equipment, but also a broader ecosystem—utilities powering the infrastructure, construction firms building facilities, sale-and-leaseback operators monetizing GPU assets, and manufacturers of advanced cooling systems. Even financial institutions, including banks and private lenders, are benefiting from the surge in financing activity tied to AI infrastructure buildout. While this interconnected growth story has supported strong performance, we contend that it also introduces concentration risk should the pace of AI-related investment normalize or decline.

Mismatched Dollars: AI Revenues vs. AI Capex

In 2025, five major hyperscalers—including Amazon, Microsoft, Google, Meta, and Oracle—are projected to spend over \$350 billion on AI infrastructure, with capital outlays expected to grow further in subsequent years¹. This surge in investment reflects extraordinary confidence in the long-term potential of AI, yet the revenue generated by the industry remains modest in comparison. OpenAI, the sector's highest-earning company, reached an annualized revenue run rate of \$12 billion as of July 2025²—a figure that underscores the mismatch between current monetization and the scale of capital deployment³. While enterprise adoption is accelerating, the gap between spending and earnings raises questions about sustainability and return on investment across the broader AI ecosystem.

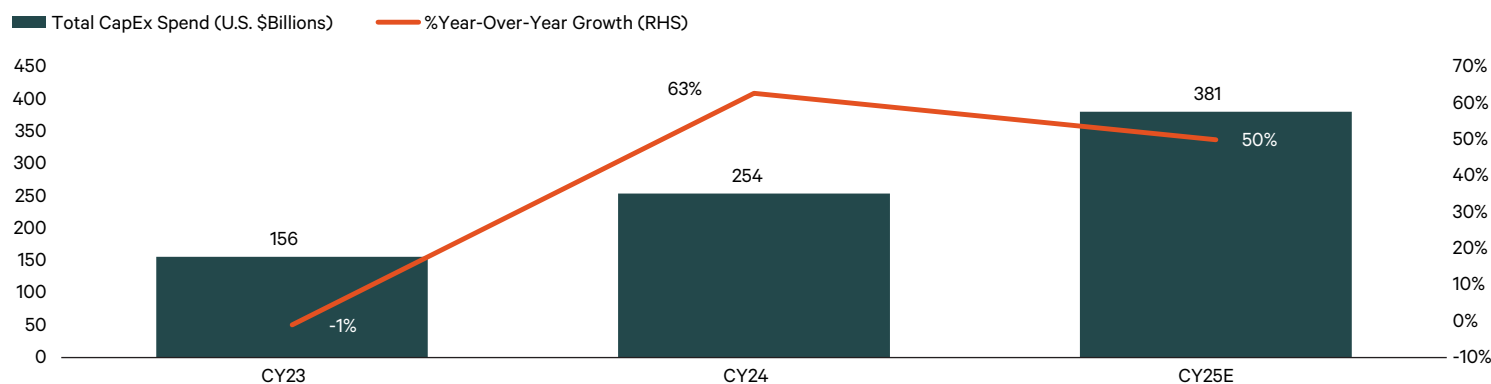
1. <https://www.econotimes.com/AI-Capex-to-Surge-in-2025-as-Hyperscalers-Boost-Spending-Says-BofA-1710012>.

2. <https://www.reuters.com/business/openai-hits-12-billion-annualized-revenue-information-reports-2025-07-31/>.

3. At the time of this writing, OpenAI had just signed an additional spending commitment with Oracle of \$300 billion for computing services. <https://www.wsj.com/business/openai-oracle-sign-300-billion-computing-deal-among-biggest-in-history-ff27c8fe>

FIGURE 1: U.S. HYPERSCALERS' CAPEX AND YEAR-OVER-YEAR GROWTH

Including Microsoft, Amazon, Alphabet, Meta and Oracle



Data presented is as of August 7, 2025. Data is obtained from Company Data and Jefferies and is assumed to be reliable. This information is for illustrative purposes and should only be used for informational purposes and KAR does not undertake to update the information presented. KAR makes no warranty as to the accuracy or reliability of the information contained herein.

Despite OpenAI's rapid growth, both the company and the broader AI industry would need to increase revenues more than tenfold to merely approach the scale of capital expenditures currently being committed—let alone exceed it, which in our view is the norm for a profitable, mature business. In typical operating models, capex represents a fraction of revenue at run-rate. In contrast, today's AI landscape is inverted: revenues are a fraction of capex. To illustrate, consider a personal analogy—your monthly car payment is usually a manageable percentage of your income. If your income were instead a percentage of your car payment, the financial strain would be unsustainable.

Generative AI is undeniably a transformative technology—one that will likely evolve into a foundational mega-theme from which many investable sub-themes emerge. Yet this long-term potential coexists with considerable near-term uncertainty: questions remain around which companies will become enduring front-runners, and around the cadence and sustainability of AI-related capital spending over the coming decade. History offers cautionary parallels. WorldCom, Global Crossing, and Lucent played pivotal roles in building the internet's infrastructure, yet none remain household names today. These examples underscore the risk of extrapolating long-term investment success from early infrastructure spending booms.

The imbalance between AI revenues and associated capital spending introduces ongoing fragility in the forward-looking capex picture. As economist Herbert Stein famously observed, "If something cannot go on forever, it will stop." For the AI industry, sustainability may be achieved either through a sharp acceleration in revenue growth or through a rationalization of current spending plans. Both paths imply a shift from today's exuberance toward a more durable equilibrium.

While the broader market leans heavily into AI infrastructure, we believe Thematic Quality offers a compelling alternative rooted in more consistent and diversified growth drivers.

The Thematic Quality Difference

Preference for Recurring Revenues

Thematic Quality is organically underweight Artificial Intelligence Capital Spending through its preference for recurring revenue business models. We maintain that these businesses, whether subscription-based or tied to consumable products, benefit from an installed customer base that compounds over time, driving steady cash flows and reducing

reliance on new sales to sustain growth. By contrast, companies dependent on one-time equipment sales face a “leaky bucket” dynamic: each year begins with the challenge of replacing last year’s revenue, leaving them more vulnerable to industry capex cycles.

To illustrate:

- **Recurring Revenue:** Software subscriptions, energy drinks, water treatment chemicals, membership-based grocery retailers, and commissions earned on annually renewing insurance policies
- **One-Time Revenue:** GPUs, CPUs, networking hardware, data center services, and commissions related to debt or equity issuance

Different Themes

KAR Thematic Quality defines themes as enduring structural shifts—driven by identifiable forcing functions—that reshape industry dynamics in favor of robust business models. By favoring recurring revenue businesses, the strategy finds itself organically positioned to benefit from themes that differ meaningfully from those dominating the broader market. Representative areas of current overweight exposure include:

1. Inflation Relief
2. Cyber Security
3. Cloud Computing
4. Digital Economy

Importantly, Thematic Quality is not categorically underweight AI. Rather, it is selectively overweight in **AI Usage Tollbooths—businesses that own the critical infrastructure and complementary software that enables productive AI usage, rather than the direct beneficiaries of AI capital expenditure.** This includes companies within the Cyber Security and Cloud Computing themes, which see revenue growth tied to increased AI usage. As the AI cycle matures and shifts from infrastructure buildout to application and integration, we see these enablers offering more durable exposure to the long-term AI opportunity.

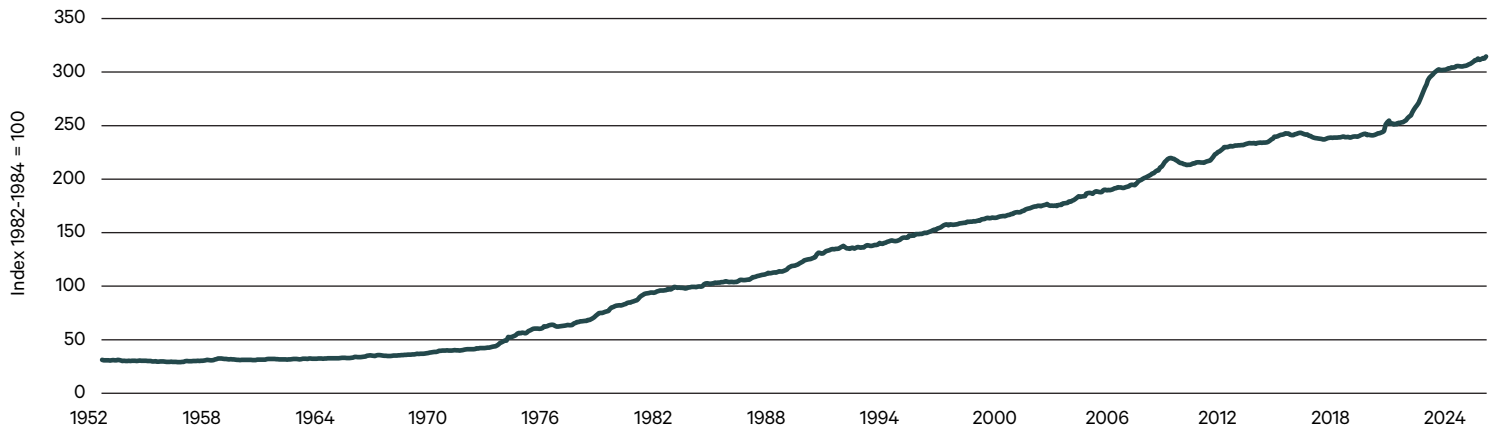
Below are some summaries of select thematic exposures within Thematic Quality:

Select Theme: Inflation Relief

Driven by elevated government indebtedness and ongoing monetary debasement, inflationary pressures are likely to remain a persistent feature of the global economic landscape. As the purchasing power of money erodes—particularly in relation to essential goods such as food—consumers are increasingly seeking ways to stretch their dollars further. From our perspective, this dynamic favors business models that deliver greater value through bulk purchasing and operational efficiency.

Retailers that concentrate their buying power into a narrower assortment of goods and suppliers can unlock scale-based savings. By passing these savings on to consumers, retailers not only deepen customer loyalty but also expand market share through value-driven differentiation.

FIGURE 2: CONSUMER PRICE INDEX FOR ALL URBAN CONSUMERS: FOOD AT HOME IN U.S. CITY AVERAGE



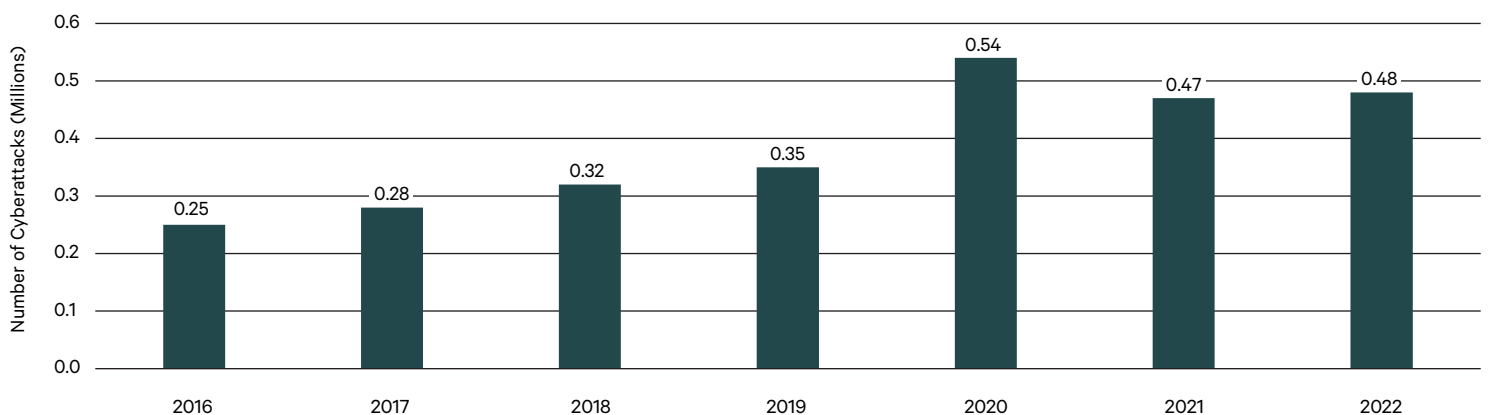
Source: U.S. Bureau of Labor Statistics via Fred. Data presented is as of August 12, 2025. This information is for illustrative purposes and should only be used for informational purposes and KAR does not undertake to update the information presented. KAR makes no warranty as to the accuracy or reliability of the information contained herein.

Select Theme: Cyber Security

The frequency and sophistication of cyberattacks have consistently escalated over time—and the emergence of AI as a powerful tool has only amplified the capabilities of malicious actors. As threats grow more complex and pervasive, enterprise organizations increasingly view cybersecurity spending not as discretionary, but as mission-critical to business continuation. This shift in mindset has transformed cybersecurity from a cost center into a necessity, with vendor revenues rising in tandem with threat volume.

FIGURE 3: ANNUAL NUMBER OF CYBERATTACKS IN THE U.S.

2016-2022, in Millions

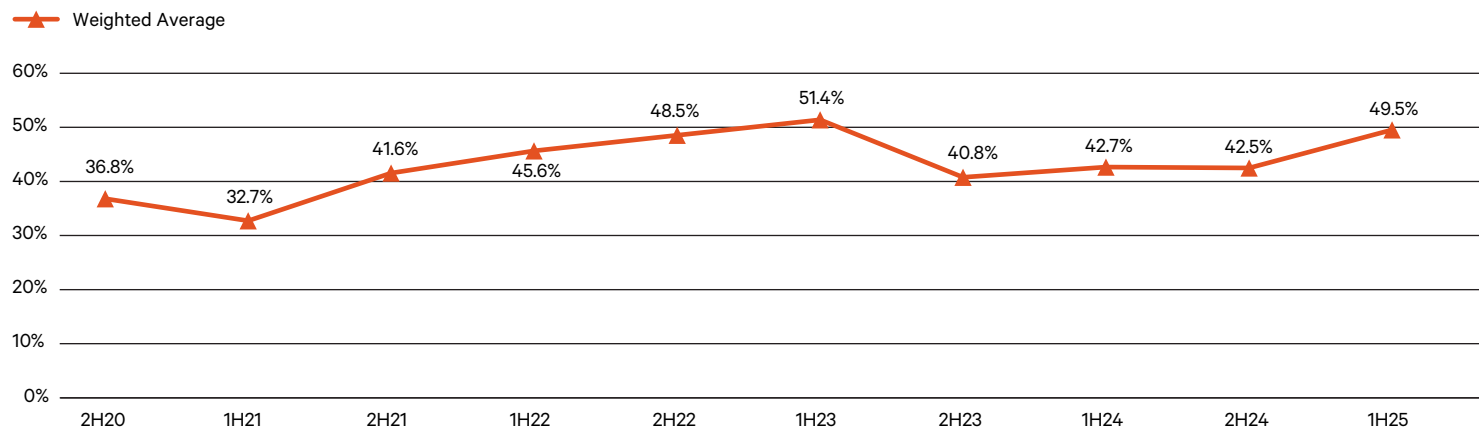


Data presented is as of June 30, 2025. Data is obtained from Statista Technology Market Insights, FBI, United States and IMF and is assumed to be reliable.

Select Theme: Cloud Computing

Cloud software offers a distinct structural advantage over legacy on-premises solutions: the ability to maintain a single codebase across multiple customer instances. This architecture eliminates the need for time-consuming and costly upgrade on-premises cycles, as updates are deployed centrally on the vendor's cloud and are immediately available to all users upon user log-in. For customers, this translates into seamless access to the latest features and security enhancements. For vendors, it enables greater R&D efficiency by focusing innovation on a unified software version rather than maintaining custom instances for individual clients. These efficiencies—both operational and developmental—are driving sustained adoption of cloud software across industries.

FIGURE 4: PERCENT OF APPLICATIONS MIGRATED TO THE CLOUD OR SHIFTED TO A SAAS VENDOR



Source: KeyBanc 1H25 CIO Survey June 24, 2025. This information is for illustrative purposes and should only be used for informational purposes and KAR does not undertake to update the information presented. KAR makes no warranty as to the accuracy or reliability of the information contained herein.

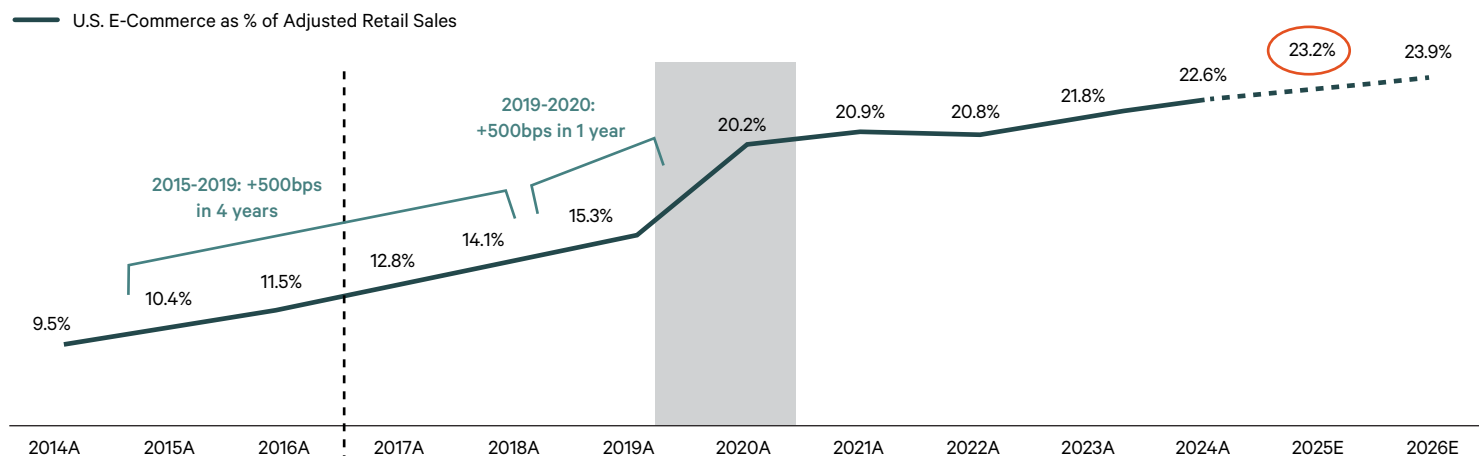
Select Theme: Digital Economy

The physical economy is constrained by frictions that delay or complicate transactions—inventory may be unavailable at a given location, and service providers may not be physically present when demand arises. In contrast, the internet offers a frictionless medium for transacting goods and services, enabling infinite shelf space, real-time availability, and asynchronous interactions between buyers and sellers.

These structural advantages continue to shift a growing share of global commerce online. As consumers and businesses increasingly prioritize convenience, access, and efficiency, digital platforms are capturing market share across retail, services, and financial transactions.

FIGURE 5: U.S. E-COMMERCE GAINS TO CONTINUE IN 2025 & BEYOND

E-Commerce as % of U.S. Adjusted Retail Sales



Source: U.S. Department of Commerce (historicals); J.P. Morgan estimates (projections). Data presented is as of June 23, 2025. This information is for illustrative purposes and should only be used for informational purposes and KAR does not undertake to update the information presented. KAR makes no warranty as to the accuracy or reliability of the information contained herein.

Idiosyncratic Business Opportunity

Thematic Quality participates in a theme only when it identifies a business with durable competitive protections that is actively gaining market share within that thematic context. These protections—such as network effects, cost advantages, switching costs, or advantaged distribution—are essential to our investment philosophy. In the open competition of capitalism, businesses without defensible barriers risk margin compression and long-term erosion of profitability.

As an actively managed, all-cap strategy with a concentrated portfolio, Thematic Quality is designed to target opportunities that are unique to individual companies. It can size up exposure to high-conviction ideas when valuation dislocations arise. **Thematic Quality's accumulation of high-conviction, quality businesses**—each facing their own idiosyncratic growth opportunity—has resulted in a portfolio that is naturally diversified from the broader market.

Examples of idiosyncratic opportunities that Thematic Quality owns:

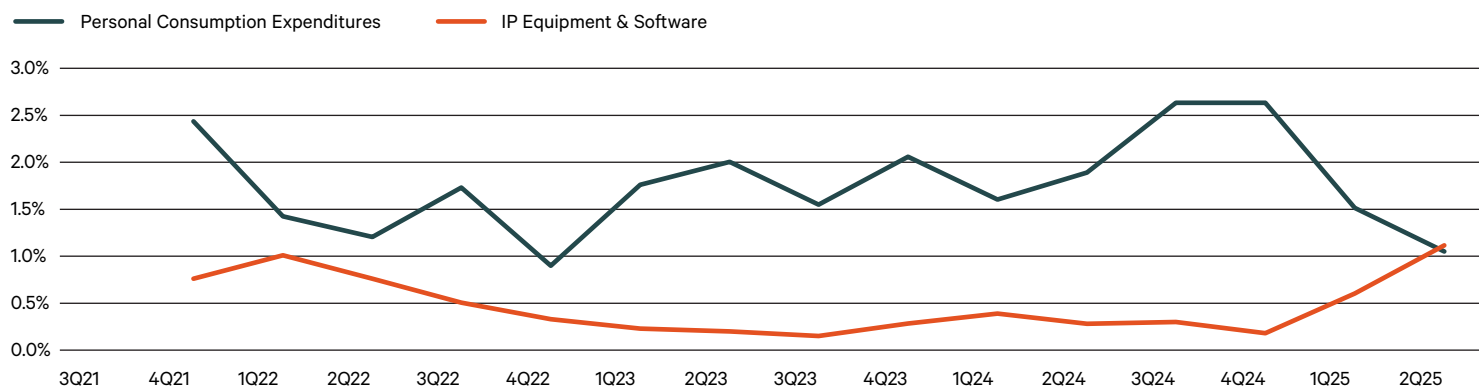
- **Tech Upgrade Cycles:**
 1. Flash memory replacing legacy hard drives
 2. Enterprise data migrating from on-premises infrastructure to cloud environments
- **Platform Expansion:**
 3. AI inference capability added to existing cybersecurity network infrastructure
 4. Autonomous driving capabilities layered onto already-computerized cars
 5. Cloud-native software embedding AI functionality to existing software-enabled workflows
- **New Category Creation:**
 6. Fitness-oriented energy drinks appealing to female consumers, expanding the functional beverage market
- **Disruptive Value Propositions:**
 7. Limited-assortment food retailers using low-cost models to outcompete traditional grocery and restaurant players

Conclusion

2025 marks a unique moment in economic history—where data center capital expenditures have surpassed consumer spending (chart on next page).

FIGURE 6: CONTRIBUTION TO U.S. REAL GDP GROWTH

% Seasonally Adjusted Annual Rate (Two Quarter Moving Average)



Source: Bureau of Economic Analysis; Jefferies. Data presented is as of June 30, 2025. This information is for illustrative purposes and should only be used for informational purposes and KAR does not undertake to update the information presented. KAR makes no warranty as to the accuracy or reliability of the information contained herein.

Even truly transformative technologies can experience periods where investment outpaces realized revenues, and quantitatively, that is the environment we face today with AI: massive infrastructure buildout, modest monetization.

Thematic Quality maintains naturally low exposure to AI Capital Spending due to three core attributes:

1. A preference for recurring revenue models over cyclical, capex-driven businesses
2. Exposure to differentiated structural themes not overweighted in the S&P 500
3. The ability to actively invest in idiosyncratic, competitively protected business opportunities

For investors seeking to diversify away from the S&P 500's reliance on continued AI infrastructure growth, an allocation to Thematic Quality may offer a more balanced equity exposure. We encourage you to explore with your advisor whether an allocation to Thematic Quality can enhance portfolio resilience and thematic diversification.

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