

Dear Shareholder,

Investing in Singularity

Building on the second quarter letter, stock markets continue to march onwards led by a singular premise, that the AI build-out will sustain the economy and stock market until such time as profits from AI materialise and do the same.

Excluding AI-exposed stocks, global benchmarks have hardly moved year-to-date, with the rest of the market up 2-3% on our estimates¹. The *equal weight* market² fell for seven straight weeks into the end of September.

We have, through choice, mostly excluded AI-exposed stocks from our portfolio, and our portfolio is likewise up a few percent so far in 2026. While clearly, we'd rather see stronger returns, what we are seeing "under the bonnet" of our portfolio companies is highly encouraging.

If they continue to generate *fundamental growth* in line with the past, at around 15% per year, in a broadly consistent way, irrespective of the many different economic outcomes, we believe the probability is very high that this will result in substantial relative performance over time.

Last quarter we discussed at some length how the uncertainty, and valuation, of AI stocks keeps us on the sideline, not fighting to pick "winners" and "losers". This time we want to discuss one small aspect of our research process which kept us out of many of the AI losers and other stocks of perceived quality.

Glass Castles

"Find a business with a wide and long-lasting moat around it...protecting a terrific economic castle, with an honest lord in charge"

– Warren Buffett, Berkshire Hathaway Annual Meeting, 1995

Pricing power is a very precious competitive advantage. Those companies with the ability to pass prices on to their customers when required can sustain themselves for longer and outcompete competitors who can't.

¹ Bloomberg

² S&P 500 equal weight index, Bloomberg

That said, when a business moves to *extract and abuse* pricing power as their primary source of fundamental growth, this can be detrimental. More specifically, it introduces fragility into the long-term durability of the business. We want castles built of rock, not glass.

Pricing power is a more potent competitive advantage when it *isn't* used, unless required. When it's pressed too hard, and pricing strategies become extractive, this actually narrows the moat to the short-term benefit of the castle / profits.

When conducting research, we always consider what the real underlying sources of growth were for a company, from both an internal financial perspective, but also in the real-world battleground of competitive enterprise.

There are many poor sources of growth we identify, and companies we avoid as a result. The specific issues from those with excessive pricing broadly break down into three areas. When we say excessive, we mean price hikes in excess of the incremental value on offer to your customers. The issues are:

1. It annoys your customers and gives them a reason to consider switching.
2. Growth led by price increases is generally very high margin. As this happens, companies tend to fatten their cost base and become encumbered with excessive expenditure.
3. It invites competition. Since the incremental growth is high margin, it often leads to higher returns on capital, a red rag to the disruptor bulls. Moreover, higher prices allow less scaled players access to your market, which wouldn't be possible if a large incumbent was well managed, and passed (most of) its scale advantages on to their customers.

These issues have recently been most common in two areas of the market: **Software** and **Discretionary Consumer Brands**.

Take for example **Adobe**, a company which has not really innovated for the past decade, yet prices have risen consistently. Operating margins grew from 10% in 2014 to 36% when they peaked ten years later in 2024. The shares are down 65% since then, and their competitive position is weakening daily.

Photoshop in particular has recently just been decompiled by coders using large language models and released into open-source coding networks. The new project is called PhotoCraft and is, effectively, crowd sourced, improving every day, and free.

No one wants to pay a subscription to edit a PDF. No one enjoyed seeing prices rise without incremental value to them. Customers will likely leave, and Adobe will have a mountain ahead of them to regain their position, which will likely come at far lower margins (if future management seeks to refill their moat) than current investors are expecting.

At the start of 2024, shares were trading at 50x trailing earnings. *Valuation* doesn't normally affect a business' *value* but in extreme cases it can. Rewarding management teams for short term or fragile business decisions with a higher multiple incentivises and perpetuates that bad behaviour.

AI has drained most software companies' moats, and in many cases, they were actually running drier than many thought.

The root cause of the issue with many discretionary consumer goods companies was the same, although the competitive threat wasn't as clear and all-encompassing as the advent of AI has been for software.

A good example of this was **Nike**. Over the past decade, supply chains simplified (notwithstanding the Covid effects) and these days it's remarkably straightforward for small designers to manufacture quality products offshore in small batches. Once they have the goods, social media and other platforms gives them distribution abilities unimaginable even a decade ago. All from a basement in Hackney.

The consumer team at Bernstein recently put this logic to the test in a brilliant piece of research. They sketched, designed, commissioned, and shipped 500 pairs of high-end sneakers. The whole process took just four months, and each pair cost less than £50 delivered, a fraction of the average selling price of shoes of comparable quality.

The success of other dedicated sneaker brands like Hoka and On Running was made possible by choices made at Nike.

On a recent trip to Boston, we popped into a recently opened Dick's House of Sport, a mecca for sports fans in the US. The most notable thing (aside from the very polished store format) was the range of brands on offer, and how little real estate Nike had in the store.

Once fragile things break, it's incredibly hard to put them back together. Nike must attempt to win back customers' faith and trust while recently empowered competitors do the same.

If you want to build a truly enduring franchise, ensuring this feedback loop of offering *much more* to your customers for *slightly more* money is non-negotiable.

Extractive brand pricing has also been met by a cyclical squeeze on consumers. Disposable income is falling across the world as the price of oil and higher interest rates eat into household budgets.

The strong demand for energy, and debt, is currently coming (yet again!) from those companies focused on rolling out AI capacity. These marginal buyers are seemingly price insensitive so, until AI slows, the price of energy and debt are likely to continue to rise.

The flip side of this is that if the AI rollout peaks, consumers can look forward to healthier disposable income, and the positive for investors is that consumer staples stocks are inexpensive today too.

Tesco, for example, trades on 14x PE. This is despite almost 20% p.a. fundamental growth in the past five years, and total returns broadly inline. The company is not exposed to discretionary spending concerns (quite the opposite) and has clearly reasserted its dominant market position. Current trading is strong, and the future bright.

In the past year the shares have been rangebound, although zooming out even a little to the five-year chart shows strong momentum. Everyone is fascinated by AI at present but opportunities like this will bear fruit, possibly at precisely the time markets need support.

Figure 1: Tesco's one-year share price and five-year total returns³



This stock is an analogy of our portfolio – strong underlying fundamental momentum (ahead of our estimates from the start of the year) yet limited short-term progress by looking at the share price. We will, as always,

³ Bloomberg, Latitude Investment Management

remain focused on delivering *value*, believing *price* will follow in time. We will give a clear breakdown of recent, and future, growth in our Annual Report in January.

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Five years ago, we were predicted to be eating non-meat burgers in the back of our renewable-powered autonomous vehicles, using our fintech banking apps to check our growing wealth from our crypto and NFT portfolios.

Since then, energy and banks stocks have roared, and the disruptors have been tossed aside. 1-0 to the incumbents. Many things can change over five years. We believe the strength of our companies' business models isn't one of them.

We don't know what the market will achieve over the next five to ten years, but we do believe we own a portfolio of consciously different businesses which can, in aggregate, compound fundamental value at close to 15% per year. We think it's highly likely this will prove to be resilient in the many different paths the world could take, not dependent on any one outcome.

If you like our approach and philosophy, there will rarely be a more opportune time to invest than today, especially versus index funds.