

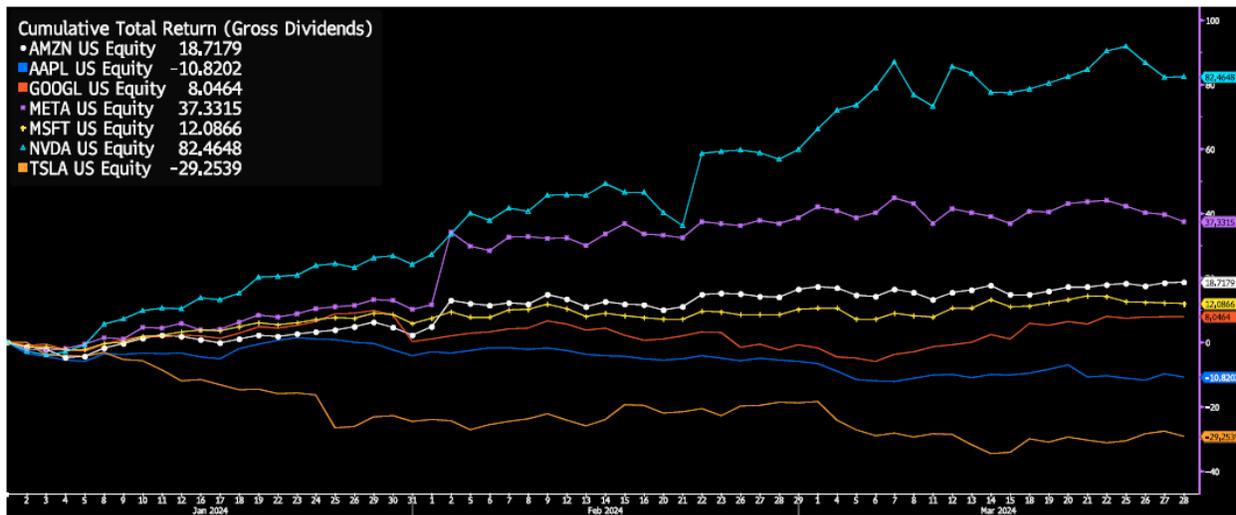


April 18, 2024

*Generative AI and Quiet Opportunities*

During the past year, discussions of generative AI have dominated the financial media. Most of the focus has been on the obvious technology players, including the “Magnificent 7.” In the commentary that follows, we will discuss the value we continue to see in our holding, Amazon, but we will also highlight other quiet opportunities that have emerged in other industries. We believe we are only in the very early stages of these technologies impacting the broader economy. On that note, our discussion will include our addition of CACI International, a small-cap firm that provides technology and cyber security solutions to the NSA and U.S. Department of Defense.

Beginning with the markets, some investors and financial commentators have warned of the market’s concentration in the Magnificent 7. Logically, the concerns are reasonable, but in a sign of market health, the concentration itself is rapidly fading. Indeed, investors have condensed the Magnificent 7 into a smaller group of winners, which many refer to now as the “Fab Four.” The Fab Four is comprised of Amazon, NVIDIA, Meta, and Microsoft.



Source: Bloomberg

As we can see in the year-to-date returns illustrated above, Tesla, Apple, and to a lesser extent, Alphabet (we remain positive), have fallen behind. The reason is both simple and in our opinion a sign of market health—these firms’ earnings growth has lagged the remaining four. As we discussed rather extensively in our annual letter, the best-performing shares in the market for 2023 represented companies with strong earnings growth. In many ways, the market has been consistent on this measure for the past twelve months, and we believe the rekindling of earnings growth among the broader set of companies in the S&P 500 has supported its 2024 rally also. In



sum, the market is simply echoing what John Templeton often cited, which is that “share prices follow earnings in the long run.” Put more bluntly, the market appears to be doing its job.

While these share price developments and trading colloquialisms are not the focus of our commentary, we will spend a moment discussing Amazon in the context of the Fab Four—for illustrative purposes.

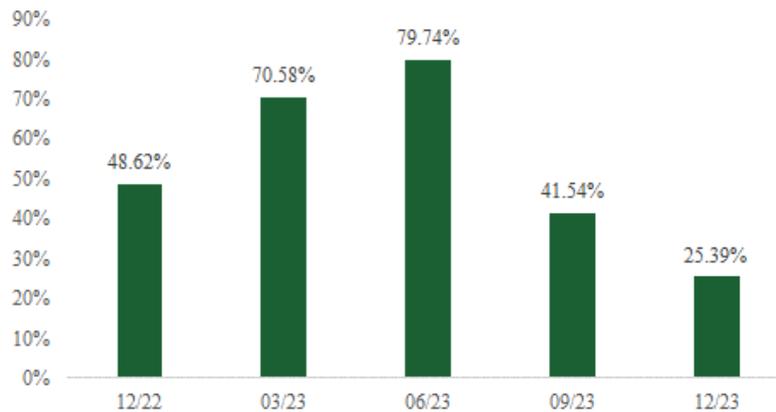
If we had to assign Amazon an identity from the original Fab Four (e.g. The Beatles), it would be the quiet one, George (Harrison). Amazon contrasts Nvidia, Microsoft, and Meta, in many ways, but from an AI perspective, we appreciate its lower profile and versatility. For Amazon, Generative AI (Gen AI) represents a service that can be sold to its cloud computing customers as well as integrated into enhanced offerings for its e-commerce and advertising customers. From an operational standpoint, the technology is being leveraged to optimize cost savings throughout its inventory, warehousing, and logistics. In contrast to the other three, the firm is taking a holistic approach. This form of radical conservatism is far from the crowds and spotlight of unveiling new GPUs (Nvidia) or the latest chatbot (Microsoft/OpenAI). However, we believe it will produce more durable growth. Much like George Harrison received less song-writing recognition than Lennon-McCartney at the height of their popularity, Harrison’s hits are still counted among the band’s most enduring. For Amazon, durable growth will prove important since this Fab Four, like the one before it, will eventually meet its own Yoko Ono.

With that preface, let us take a closer look at Amazon and explain why we believe its recent returns are justified, and also why we view it as a strategic leader for the role of artificial intelligence in our portfolio.

Before we dive in, let us rewind with a brief history of the purchase and how the holding came into the portfolio. The day was March 12, 2020, and in the depths of the market’s COVID-induced panic, we added Amazon shares to the portfolios making it one of the portfolio’s largest holdings. Coincidentally—purely coincidentally—Amazon’s shares touched their pandemic low on that same day. To be sure, our focus was not on timing the bottom, but instead on timing an exceptional bargain at 12.0x cash flow in a well-run company with years of potential growth still in its future. More generally, we were prioritizing firms that we believed could fund themselves internally during a difficult economic environment, and therefore continue to expand and add shareholder value in a downturn. Fast forward to 2024, and we believe that Amazon’s growth potential, fundamental strength, and valuation (11.9x cash flow) still meet our original criterion for investment. Importantly, we believe it is well suited for today’s other popular financial colloquialism—higher for longer (interest rates).

Returning to Amazon’s earnings and cash flow growth potential, we believe the market has rewarded shares on that basis, not AI speculation. This view is supported by an impressive string of earnings surprises over the past year, illustrated in the graph that follows.

### Amazon EPS Surprises (% Increase above Est.)



Source: Bloomberg

Given our earlier discussion of the Magnificent 7 and its evolution into the Fab Four, you might expect us to spend the rest of the commentary holding a pep rally for Amazon’s AI opportunities. Not so, we see much more than AI driving recent gains, and we believe that is a good thing.

One good example can be seen in the firm’s rapidly growing advertising business. Advertising has always seemed like a natural growth engine to complement its e-commerce business, and this income line item has begun to thrive.

During 2023, the firm’s advertising business increased 24% year-over-year and now represents a \$47 billion business. The recent result in 2023 heralds advertising as the company’s fastest-growing and most profitable business, with a 53% sales CAGR dating back to 2015. Based on these growth and margin relationships (including its low penetration among its online sellers), it appears likely that over the next several years Amazon’s advertising business will eclipse \$100 billion in sales. With the advertising business carrying approximately 50% operating margins, this business is poised to become the firm’s largest profit driver. While many investors would salivate to own a firm growing revenue at these rates with approximately 50% operating margins, we see Amazon’s advertising business as one of several potential growth engines at the company. Looking even further out, we will be interested to see Amazon’s ability to innovate its advertising business by applying its internal expertise with artificial intelligence. One possibility could be found in the eventual democratization of video advertising to smaller businesses as AI can generate content faster and cheaper than conventional ad studios, which have represented a walled garden for large consumer companies with considerable ad budgets.

Of course, any discussion of Amazon’s growth potential must include its long-running crown jewel, Amazon Web Services (AWS). For Amazon, AWS represents its fountainhead of profits and cash flows providing reinvestment opportunities across the business. AWS is widely regarded as the leading cloud infrastructure firm in the world, with approximately \$91 billion in revenue by the end of 2023. A large piece of its success is attributed to its groundbreaking pay-per-use model that allows its customers to optimize their cloud computing needs, a break from



the traditional subscription model for computing and software services. Aside from its clever breakthrough in pricing and sizable barriers to entry through \$155 billion in capex, AWS continues to benefit from the steady migration of corporate data centers to a public cloud solution. Turning to AWS's generative AI (Gen AI) opportunity, we see a company that is moving from strength to strength based on these developments. The basic premise here is that AWS provides a turnkey computing platform including the necessary tools to create a large language model (LLM) or broader AI strategy. For AI adopters (customers), the sheer amount of capital needed to create an AI solution represents a barrier to entry for most companies seeking a Gen AI solution. Also important, the AWS's LLM service, called Amazon Bedrock, does not mandate the use of its own LLM solutions and allows customers to bring their own solutions, whether produced in-house or from third parties. Bedrock contrasts Microsoft's strategic focus on their proprietary Gen AI solutions. Amazon has a wide array of Gen AI apps and tools for customers to deploy, and the initial feedback from the company is that its customers do not seek a single large language model solution, but instead seek several different applications of the technology for different uses at their firms (e.g., demand is larger than expected). While the Gen AI opportunity remains in its early stages for AWS, Amazon's CEO, Andy Jassy has stated that the technology will generate "tens of billions of dollars" in additional revenue for the firm over the next several years. Based on our estimates, we believe that AWS has the likely opportunity to increase its revenue to \$200 billion by the end of the decade.

Not to be outdone by the high growth and high margin services businesses of AWS and Advertising, Amazon's traditional e-commerce business posted significant margin improvement over the course of 2023, which helped drive the company's consolidated operating margin to 6.4% from 2.4% in 2022. In this case, the company's large investment into a regional fulfillment system—a departure from its national model—has led to a permanently lower cost structure, owed to lower fuel costs. Interestingly, we also see the potential for Gen AI applications in the e-commerce business to move it from strength to strength compared to its competitors. In this case, the company is introducing Gen AI applications for its shoppers that can summarize thousands of product reviews, as well as help make sizing and fit selections on various apparel items. Also, the company has introduced a Gen AI shopping assistant that can provide product explanations, advice, comparisons, and other valuable information drawn from its expansive catalog.

This leaves for discussion what remains the most important piece of the Amazon calculus, in our view, which is its share price valuation. In this case, we have been relieved over the course of the past year that the company's surge in growth has been accompanied by corresponding cash flows, which in turn has kept the firm's valuation at an attractive level. Applying a simple measure, in this case, Amazon's price to cash flow of 11.9x, we can see a comfortable cushion relative to its estimated long-term growth rate in cash flows of 17% annualized, as well as the S&P 500's price to cash flow of 15.0x.

As we mentioned at the outset of the commentary, we believe the opportunity set related to growth in Gen AI, and other AI applications extends well beyond the confines of big tech and the Fab Four. With that said, we will take a moment to share with you another recent investment we added earlier this year into a small-cap stock that we believe quietly captures a few important



tailwinds, including the growth in AI technologies. CACI International may not be a household name, but it plays an important role as a leading consultant and provider of technology solutions to the U.S. National Security Agency and Department of Defense. From a product and service standpoint, the company’s offering touches several different areas, including the modernization of government technology infrastructure, such as migrating systems to the cloud. Additionally, the company also offers a wide array of services and software surrounding communication and surveillance technologies, and importantly, cyber security. During the past 20 years, the company has posted an annualized growth in revenue and earnings per share of 10% and 12%, respectively.

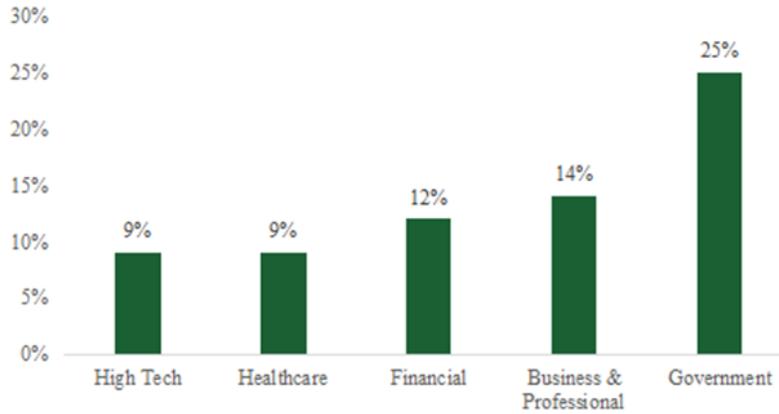
Given its strong track record, we were surprised to find the shares trading at a significant discount to its nearest competitor, the much larger firm, Booz Allen Hamilton. However, and as we have mentioned many times during the past 12-18 months, we are continuing to find material discounts in U.S. small-cap equities. In the summary below, we can see CACI’s comparison across various valuation and fundamental measures versus its large-cap peer. In sum, despite its faster earnings growth, CACI International trades at a 41% discount (P/E) to its larger peer.

	<u>CACI Intl., Inc.</u>	<u>Booz Allen Hamilton</u>
Market Cap	\$8.2 Billion	\$18.8 Billion
Next 12M P/E	15.3x	25.9x
Free Cash Flow Yield	6.4%	2.7%
Hist. EPS Growth	12.1%	5.8%
Est. EPS Growth	13.8%	14.3%

As you already know, we enjoy finding pricing discrepancies like the one above, but in this case, we are more optimistic about CACI’s valuation relative to its potential to accelerate growth in the years to come. We believe CACI’s growth may accelerate based on geopolitical conflicts increasingly playing out in the technology sphere and an overall acceleration in cyberattacks owed to the broader adoption of AI technologies.

Unfortunately, AI tools are also being adopted for nefarious reasons, many of which are state-sponsored and are taking aim at other governments and their infrastructure. Based on data shared by Palo Alto Networks, phishing emails have increased 10-fold in the past twelve months and nation-states have been observed attempting to use AI for attacks on other countries’ technology and networks. Similarly, The Economist has reported that in the past three years, ransomware attacks have increased nearly four-fold. The bottom line is that AI can be utilized to create malware in a fraction of the time it requires humans to do the same. Problematically, governments continue to rank as the number one target for these attacks.

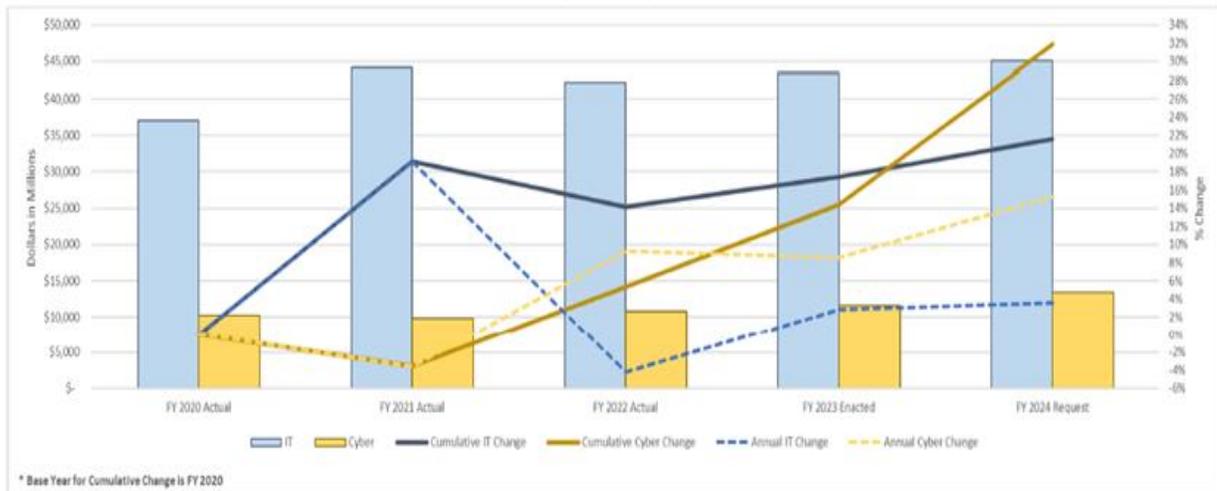
### Top Industries Under Attack



Source: Mandiant

In the meantime, this new reality is showing up in the U.S. Department of Defense Budget, with the cyber budget representing the fastest-growing category.

Table 1: DoD IT and Cyber Budget Trend Across 5 Years



Source: President's Budget, 2024 Budget Request

As evidenced by the 32% four-year growth in the proposed cyber budget, it is relatively clear that cyber security is an increasing priority for the Department of Defense. This is important for CACI for two reasons, with the first and most obvious being the opportunity for revenue growth, but also the second being the potential for margin expansion over time since these contracts tend to carry higher margins. CACI's strategic push towards heavier technology content in its contracts has helped the firm increase its EBITDA margins from the low 9% range to over 11% during the past ten years.



As we reflect upon these opportunities, we remain cognizant of many other potential sectors we are currently researching that may benefit from the growth in AI technologies. The basic summary is that we believe developments in AI are quietly beginning to impact many old-economy industries well beyond the obvious technology names. We believe these developments represent exciting potential for investors conducting independent research.

Templeton and Phillips Capital Management, LLC

A handwritten signature in black ink that reads "Lauren C. Templeton".

Lauren C. Templeton  
Principal

A handwritten signature in black ink that reads "Scott Phillips".

Scott Phillips  
Principal

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