WHY THE NASDAQ-100 MAY NOT CAPTURE THE FULL GROWTH POTENTIAL OF AI…AND WHERE TO LOOK INSTEAD

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The start of 2023 has marked the return of tech growth stocks alongside the surge of generative artificial intelligence (AI) and large language models (LLMs). The biggest tech companies in the world have benefitted from the buzz created by ChatGPT and rapidly rising enthusiasm around AI in general. Nvidia, a leading semiconductor company seen as one of the main AI beneficiaries, has advanced the most within the Nasdaq-100 and even joined the trillion-dollar market cap club just weeks ago.

The year-to-date rally of 'Big Tech', led by Nvidia, has resulted in a strong return differential of 22.33%[1] between the widely followed tech gauge (the Nasdaq-100) and the broad equity exposure (the S&P 500). In Figure 1, the top 10 holdings in the Nasdaq-100 by contribution to return (CTR) have jointly posted 30.45% year-to-date, representing more than 82% of the total index return. This advance of the top Nasdaq-100 holdings, capitalising on the buzz around AI, is begging the question from investors whether allocation to the Nasdaq-100 already offers good exposure to the long-term investment potential associated with the AI megatrend.

Figure 1. Top 10 holdings by contribution to year-to-date return within the Nasdaq-100

	Average weight	Total return	CTR
NVIDIA Corp	5.09%	186.63%	6.13%
Apple Inc	12.22%	45.16%	5.29%
Microsoft Corp	12.56%	40.16%	5.02%
Meta Platforms Inc - Class A	3.53%	138.53%	3.44%
Amazon.com Inc	6.42%	53.79%	3.31%
Tesla Inc	3.49%	103.13%	2.75%
Alphabet Inc - Class C	3.81%	34.13%	1.36%
Alphabet Inc - Class A	3.83%	34.12%	1.35%
Broadcom Inc	2.09%	53.66%	1.09%
Advanced Micro Devices Inc	1.15%	70.43%	0.71%
Top 10 holdings by CTR	**54.2%**		**30.45%**
Nasdaq-100	**100%**		**37.03%**

Source: WisdomTree, Bloomberg. Period from 30 December 2022 to 27 June 2023. Nasdaq-100 is represented by the NASDAQ-100 Notional Net Total Return Index. Average weight is the average weight of a holding in a given fund/index during the specified holding period. Total return is each stock's total return in USD. CTR is each stock's contribution to return in a given fund/index.

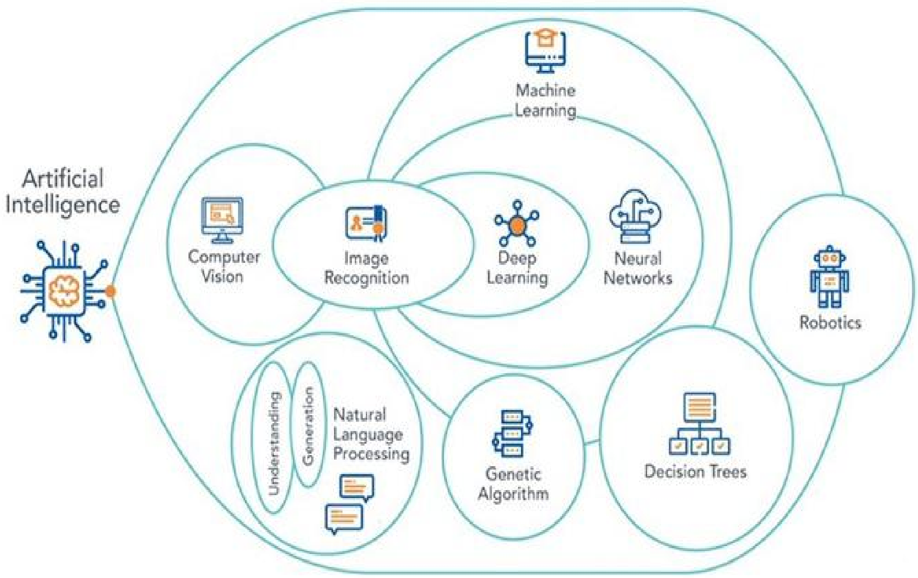
You cannot invest directly in an index.

Historical performance is not an indication of future performance and any investments may go down in value.

To answer this question, we have to take a step back and think of the concept of megatrends and benchmarks in the portfolio construction process. Benchmarks are usually viewed by investors as a core allocation, while thematic investing is being used as a return enhancement play that benefits from the evolution of various megatrends. In the case of the Nasdaq-100, we can point to several arguments why a thematic strategy focused on the AI theme might be a better option if an investor's goal is to benefit from the long-term growth potential offered by AI.

1. The AI space represents a wide variety of areas that can achieve wider adoption and success at various points in the future. A targeted AI strategy can build exposure to the theme and its evolving trends through a diversified basket of more pure-play companies involved in various AI activities. In turn, the Nasdaq-100 will tap into the space only through a handful of companies that would offer a less comprehensive and less pure exposure to the theme.

Figure 2. The various fields of artificial intelligence



Source: WisdomTree.

2. A targeted AI strategy has the potential to capture the mega caps of tomorrow early on and with a meaningful weight within the portfolio. Investing in AI through the Nasdaq-100 might be seen by investors as a safe way to avoid losers and focus on more successful AI companies that made it into the benchmark. However, this approach does not allow investors to reap the return potential associated with exciting smaller companies early on. After all, the growth potential driving the returns in the tech space is highest for smaller and younger companies.

Look at Tesla and Nvidia (the latest two companies that managed to hit a $1 trillion market cap) in Figure 3. Investing in them 3 months after they went public would have resulted in much higher annualised returns in comparison to returns after they joined the Nasdaq-100. In addition, it took both companies around 2-3 years to join the tech benchmark and, after they did, their starting weights were only 0.40%-0.50%. In contrast, thematic strategies might invest in companies shortly after their IPO (initial public offering) dates and might allocate a more meaningful weight to them.

Figure 3. Returns of Nvidia and Tesla shortly after their IPO dates and from the dates they joined Nasdaq-100

	NVIDIA Corp	Tesla Inc
Annualised total return from IPO date + 3 months	33.84%	49.65%
Annualised total return after joining Nasdaq-100	24.56%	40.48%

Source: WisdomTree, Bloomberg. As of 27 June 2023. NVIDIA Corp went public on 21 January 1999 and joined Nasdaq-100 on 31 May 2001. Tesla Inc went public on 29 June 2010 and joined Nasdaq-100 on 15 July 2013.

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3. A satellite thematic exposure can improve the risk-adjusted portfolio returns through increased diversification. The concept of diversification was first formalised by H. Markowitz as early as in 1952. However, in practice, it's not feasible to hold all stocks in the investable universe and investors stick to broad benchmarks to build their market exposure. In this situation, thematic investing represents a novel way to split the universe of investable companies and identify promising opportunities aligned with megatrends shaping our future. Relatively low overlap of thematic strategies with broad benchmarks is what makes them particularly attractive for a satellite exposure.

Trying to kill two birds with one stone (that is, building a core tech exposure and capturing the potential of the AI theme) by using the Nasdaq-100 could backfire. It could deteriorate diversification and risk-adjusted returns for two reasons: 1) Sticking just to AI companies within the Nasdaq-100 narrows down the return drivers associated with the AI megatrend; 2) Investors increase idiosyncratic risks in their portfolios associated with the biggest tech companies, most likely captured in some other portfolio allocations, for example, the S&P 500.

Thematic strategies specifically focused on AI might represent a better option for investors seeking to benefit from the long-term growth potential associated with the megatrend in contrast to the theme exposure offered through the Nasdaq-100. When selecting the specific AI strategy it's important to understand how each strategy captures the space and to align it with investor's beliefs about the future development of the megatrend. Diversification benefits and potential return drivers associated with the theme are yet other important considerations that help to govern the strategy selection process.

Sources

[1] As of 27 June 2023.

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