

No HALO Effect: Embrace Creative Destruction and the Opportunities It Provides

- One of the questions I am frequently asked is: How are you managing all the uncertainty and pockets of market volatility surrounding news of AI disruption with a doomsday bent?
- The short answer is that risks in today's market are idiosyncratic: With diversification and sound portfolio management, there are viable ways to mitigate those risks - and even find investment opportunities.
- How is this accomplished? A framework was developed called **HALO**, which stands for **Heavy Assets, Low Obsolescence**. What is HALO? Let's get into it!

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner powered by The BEAT, our asset allocation framework across Bonds, Equities, Alternatives, Taxes and short-term Transitional (cash) investing.

The title of this Caron's Corner is **No HALO Effect: Embrace Creative Destruction and the Opportunities It Provides**. One of the frequent questions asked is how are you managing all the uncertainty in the pockets of volatility in the market surrounding all the AI disruption news that takes on a doomsday bent? Well the short answer is that the risks in markets today are idiosyncratic, and through diversification and sound portfolio management practices, there is opportunity to mitigate these risks and even find opportunities. Let's get into it.

I want to talk about AI, creative destruction, asset valuations and managing these risks - and obviously capturing these opportunities. A framework was put out. It's called HALO - **HALO** – which stands for **Heavy Assets, Low Obsolescence**. It's a new term coined as a way to manage current market risks. Conceptually, we see it as a starting point, but there's much more to it. Let me explain. Our investment philosophy around these issues is in ten steps.

1. Disaggregating HALO framework HA stands for heavy assets. These are durable, hard to replace assets. Real assets, infrastructure, commodities and certain industrial platforms tend to provide inflation resilience, be capital intensive and are difficult to replicate – and offer embedded scarcity. Value is another point. Some historical examples of this are energy and real estate assets outperform during the 1970s. Inflation, infrastructure and hard assets reprice positively during the post-COVID supply constraints. Now LO. That part of HALO, Low Obsolescence, is harder to achieve. Low obsolescence runs counter to innovation, productivity gains, technological progress as markets evolve. Creative destruction is a feature, not a bug, in the system. True obsolescence in high growth assets are really rare and hard to find. Take for example railroads, which were once thought permanent. Then trucking and aviation reshaped transport. Kodak had a brand durability, but technology obsoleted the business model. So what are the conclusions? You cannot avoid obsolescence. You must manage it.

2. The core attention in investing. Let's identify that there is a structural conflict between high growth and returns and low obsolescence and stability. Innovation increases growth potential, but raises obsolescence risk. As investors, we embrace productivity gains. We actively manage obsolescence risk. We avoid confusing durability with permanence.

3. AI is creative destruction in real time. AI is not cyclical. It's structural. It will disrupt labor models, cost structures, pricing, power and capital allocation. It will reprice assets, where business models rely on scarcity of knowledge, process or distribution. The key investment question though, is does AI disruption collide with leverage in a way that creates contagion, or does it remain dispersed? Let's talk about that.

4. Contagion versus dispersion. Contagion we see as systemic risk. That's disruption plus high leverage, forced deleveraging, rising asset correlations, cross-asset correlations and credit stress. The historical analog obviously is the 2008 financial crisis. Housing disruption and leverage created systemic contagion. On the other hand dispersion is a broadening of the opportunity set. Disruption concentrated in specific sectors is something to look for. Limited spillover into credit and funding markets. Broader macro backdrop remains stable. And this is pretty much what we're seeing today. Some historical analogs are the dot.com bubble from 2000-2002. We had severe equity dispersion but contained credit stress, cloud and software transitions back in the 2010s. While legacy tech compressed, new platforms compounded. Today's environment looks more like dispersion than contagion. Stress is concentrated. Credit markets are not signaling systemic stress. Macro backdrop of employment earnings, inflation all remain broadly constructive.

5. We believe this environment favors active management. Why? Well think about AI driven volatility. It creates valuation gaps. It widens dispersion across sectors and factors, punishes incumbents while rewarding productivity beneficiaries. Passive strategies, on the other hand, must own both the disrupters and the disrupted, and they cannot selectively avoid obsolescence risk. Active strategies can stress test balance sheets, avoid high leverage businesses or business models exposed to technological displacement rotate, and can also rotate into productivity beneficiaries. Historically, periods of high dispersion can be seen in the early 2000s and the post GFC tech cycle. It rewarded selective positioning.

6. AI creates valuation risk. What to watch for? Well, business models more reliant on information scarcity, labor-heavy cost structures with limited pricing power, high fixed costs plus leverage plus low switching costs and companies priced for perpetual growth but facing margin compression. These are all things to watch for. Valuations adjust fastest when growth assumptions meet structural margin pressure, and disruption meets leverage.

7. AI creates opportunity. AI is also a productivity shock. Potential beneficiaries include companies with scalable platforms, asset light models leveraging data and network effects, hard asset owners that integrate AI to improve margins and infrastructure enabling compute, energy and connectivity. Some historical parallels to think about are 1) electrification, which in the early 1900s disrupted some industries but transformed many others and 2) The internet buildout, which destroyed traditional media economics, but created an entirely new ecosystem. Creative destruction reallocates capital, it doesn't eliminate it.

8. Multi-asset implications. Let's go down the list. In equities, expect wider dispersion, emphasize balance sheet strength and pricing power, and avoid highly levered legacy models vulnerable to automation. In credit, monitor leverage and technological vulnerability, but also take a look at contained dispersion, which means that credit remains stable or signs of contagion, which means that rising correlations and funding stresses might impact the assets. In real assets, hard assets remain valuable in inflationary regimes. AI increases demand for power, data centers and infrastructure. With respect to portfolio construction, this is extremely important. We can't stress this enough. Diversify across disruption, beneficiaries and durable asset classes. Stress test correlations under a leverage shock and lean into volatility when it reflects dispersion, not systemic risk.

9. AI is destruction. It is creative destruction, I should say, in real time. This is what the bottom line is. The risk is not disruption alone. The risk is disruption, plus leverage today looks more like dispersion than contagion. Dispersion creates pricing gaps. Pricing gaps create opportunity. Our job is not to predict every AI winner. Our job is to manage obsolescence, stress test leverage, exploit diversion, dispersion and allocate capital where productivity gains compound.

10. Execution. I always like to call this one out. Execution. Creative destruction creates headlines. Disciplined active management may convert into returns when you execute through this investment philosophy.

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