In The Know: Episode 61

From search to answers: How AI is changing the game

Announcement (00:00):

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Host (00:14):

This is In The Know, a monthly investment podcast brought to you by Magellan Investment Partners.

Casey McLean (00:20):

For the first time in two decades in Google or Alphabet's history, they're facing a credible threat to their business model, and it really boils down to whether you believe that AI is a massive new opportunity for them or an existential risk.

Host (00:35):

That's Casey McLean, portfolio manager for the Magellan Global Fund. Welcome to In The Know. Online Search tools have shaped the way we've engaged with information for more than 20 years, but with the emergence of generative artificial intelligence, the simple Google search box is undergoing its most significant change yet. So, how exactly is generative AI impacting online search tools and what will the future of search look like? In this discussion, Casey McLean joins Magellan's investment director and analyst, Elisa Di Marco, to unpack these timely questions. Casey also shares how Google's parent company, Alphabet is navigating this transformation, highlighting the implications for investors.

(01:25):

To kick things off, a welcome from your Host, Elisa Di Marco.

Elisa Di Marco (01:32):

Welcome to Magellan's In The Know podcast. My name is Elisa Di Marco, investment Director and Analyst at Magellan. And today I'm joined by Casey McLean. Casey has 24 years of industry experience, is a newly appointed portfolio manager to the Magellan Global Fund, and important for today's conversation, he's a technology enthusiast. Welcome, Casey.

Casey McLean (01:51):

Thanks very much, Elisa. Great to be joining the team and with you on the podcast today.

Elisa Di Marco (01:55):

Absolutely, it's been a pleasure having you in the team and it's going to be a great discussion today. So, today we're going to delve into the wonderful world of search, but with a focus on the future. So, Casey, to first set the scene for us, can you talk us through what is the fundamental difference between search and generative AI?

Casey McLean (02:14):

Well, Elisa, the fundamental difference really comes down to the intent and the complexity. So, if you think about traditional search for the last two decades, we've been mainly using it for three things, for informational queries such as what is the capital of Queensland, that's about 55% of queries. Then for navigational queries, like find the Magellan Financial Group website, that's another 30% of queries. And then commercial queries such as buy flights to Melbourne, that's the remaining 15%.

(02:45):

So, you can see with these traditional Google search queries, they really have a very specific intent, and it does this by having a really highly optimised retrieval process, which finds and retrieves existing information based on a vast index of all the websites on the internet. Whereas generative AI on the other hand, it really excels at complexity and creation. The majority of the uses for generative AI are in deep research and assistance. It's things like summarising long reports, it's debugging code. If you're a coder, it's help with your homework or doing deep research on a particular topic.

(03:26):

And what it does, instead of just retrieving the information, it actually goes out, uses a generative process to create something that's new. It's customised, and importantly, it's unique to each and every prompt. And what that means really is that there's pretty limited overlap between the two types of queries. In fact, only about 30% of AI queries have overlap with traditional search. So, what it means really in short, is you used traditional search in the old world to go out and find that needle in the haystack. Whereas generative AI, you're actually asking it for a new needle that you're designing exactly how you want it.

(04:06):

And what it means for Google itself is that they're really undergoing a fundamental shift away from being a search engine to becoming an answer engine.

Elisa Di Marco (04:16):

That's such a neat distinction, Casey there that we're switching from being a search engine to an answer engine. And I imagine for a lot of people listening, they can really see how that's been working in practise and then how we're going to be able to get those efficiency gains, those time savings from AI, which is really driving the excitement around AI at the moment. So, how do you envisage Casey that Google is going to be transitioning from that search engine to the answer engine?

Casey McLean (04:44):

Well, it's an evolution and it's already happening, and it's really central to Google's strategy. And the core of the change really is moving away from just providing a list of those blue links like you would've seen in the past to providing a direct and comprehensive answer. And they've already started doing this by including AI overviews, which you've probably seen, they've rolled it out now to one and a half billion users. It's that box at the top of the search results, which has a quick summary. It's an automated passive summary based on the response to the query, but now they're even going one step further and providing what they call AI mode. It's just been released in Australia.

(05:26):

And what allows is for a much deeper dive into that query, you can have advanced interactive conversational type experience with the AI, and all you need to do is click on the rainbow button at the bottom of the AI overview or click in the AI mode tab. And that's really the full fat AI experience. It's what you want to use when you have multi-part complex questions that require that deeper exploration, because it also allows you to refine answers, have follow-up questions, and really get the specific information that you need. So, what it means for Google really is that in one screen, you're getting this smorgasbord of information.

(06:08):

You've still got those links, the little blue links, which are the most relevant websites to what that query is. Plus, you're also getting a concise AI-generated summary all in one place. And now, you're getting this opportunity to really immerse yourself in this conversational in-depth AI research experience as well.

Elisa Di Marco (06:27):

Yeah, no, I couldn't agree more on what I've found so exceptional about what Google's done with AI overviews and AI mode is just how incredible that user experience is that you're able to transition from search in some queries to that answer engine, which has been really exceptional-

Casey McLean (06:42):

Absolutely.

Elisa Di Marco (06:44):

... for the consumer. So, just pivoting a little bit now, and I imagine that a lot of the audience may not appreciate that Alphabet is actually the pioneer of AI. Now, given this fact, Casey, why has this transition from search engine to answer engine been a really key or critical investment debate for Alphabet more recently?

Casey McLean (07:05):

Well, yeah, you're right, Alissa. It has become a key debate, and really that's because for the first time in two decades in Google or Alphabet's history, they're facing a credible threat to their business model for the first time. And it really boils down to whether you believe that AI is a massive new opportunity for them, or an existential risk. And really, there's three risks that investors are worried about at the moment, and the first is the risk to revenue. And when you think about the fundamental business model of traditional search, Google gets paid by when you click on a link.

(07:42):

Whereas in the AI world with these AI overviews, they bypass that step by giving you this comprehensive direct answer, which means the click-through rate or the amount of users that actually click on one of those links is much lower in searches that include an AI overview than in the traditional search. And that makes a lot of sense when you're doing one of these informational searches, that 55% of searches, you've got all the information you need. So, there's no need to click on one of those links and go further and giving Google makes money from you clicking on those links, that is a risk to their revenue, unless they can find other ways to monetize AI or new sources of revenue. The second risk is around margin compression.

(08:26):

And that's because AI queries are structurally much more expensive to execute than traditional search. And that really comes down to the compute cost. AI queries cost about 10 times the amount that a traditional search query does, and that's really because the AI goes out and it generates a new answer from scratch every single time, and it uses expensive GPUs to conduct that work. Whereas traditional search, like we said earlier, it's about a retrieval process of this cache information and it can do that using much cheaper CPUs. So, again, there's this risk that margins could be impacted over time as the mix of queries shift towards AI. And then finally, I think the other key debate is around competition.

(09:17):

The increased competition in the AI era. In traditional search, Google had a virtual monopoly. They had over 90% market share, which was very hard to penetrate and really didn't have any meaningful competitors. But in the AI era, it's very different. There's much more players, and it's unlikely that Google is going to command such market dominance with this new much more competitive landscape that's emerging.

Elisa Di Marco (09:42):

Let's drill down into that a little bit more because when we are thinking about what makes a quality company, it's that industry structure, which is often one of the features that we're looking for. So, what's your vision in this future of search? Is it going to be a monopoly for Alphabet, a duopoly with ChatGPT, or will the landscape be considerably more competitive?

Casey McLean (10:03):

Well, the AI industry is very much at a nascent stage. You have to remember, ChatGPT was only launched for the first time in November 22. And so, the competitive landscape, it's very dynamic, it's constantly evolving. And as we see it today, there's at least a dozen players who are all trying to be at the forefront of AI development and lead in the industry, and it's really unlikely that all of them will succeed. We think there will be market consolidation over time. The question is who and how many will win? And from our point of view, Alphabet has all the tools to win in the AI era. In fact, they're probably the most uniquely positioned company that is competing for the AI supremacy at the moment.

(10:49):

When you think about it, they're the only company to have the combination of having a leading AI model in the form of Gemini. They also have their own custom chips, which are known as GPUs. They're able to deploy those chips on their own cloud platform. And then they have this huge global user base across a suite of products that they're able to integrate AI into. And critically, they also have really strong cash flow support. So, if we were to drill down on a couple of those as well, I think the importance of that large user base and the diversity of products that they can integrate AI into cannot be underestimated. It's not just search where they have five billion users globally.

(11:33):

It's also the other products like Android, YouTube, Gmail, Maps, all of these products have between two and three billion users globally and would all benefit from using AI. And it's also a great way to roll out their AI services. And then if you think about cash flow, that's becoming an increasingly large constraint for some of the smaller, less mature players, and that's because AI is incredibly expensive to develop. If you think about the top six players in the industry now, they're on track to spend almost half a trillion dollars in CapEx this year alone. That's a huge number to give an idea-

Elisa Di Marco (12:14):

It's phenomenal, isn't it?

Casey McLean (12:14):

... of the scale. Yeah, it's massive. It's actually the same size as the GDP of the Philippines, a country with 116 million people, and it's only going to get larger. Every new model that they're bringing out costs more and more to train and develop. And if you don't have the cash flow support of another business or access to capital markets, it's going to be really hard for these players to compete in the longer term. So, yeah, I think it's a very early stage. It remains to be seen who's going to win, but we think Google is in the race definitely and pretty well positioned to be one of those leaders.

Elisa Di Marco (12:50):

Yeah, I like the way that you summarised a lot of that there, that Alphabet's foundations to be in the race is really critical that it's got those strong cash flows and it has the customer base. I think from our analysis of quality companies over the years, having the customer base is such a critical element because it means that you don't have to go and pay to acquire that new customer. You already have them on your books where you could then cross-sell them a new product, which is what we've already seen with AI overviews and AI mode, and they've been able to gain traction with those really quickly.

Casey McLean (13:21):

Absolutely.

Elisa Di Marco (13:22):

So, when we are then thinking about this monetization of AI, how do we do that? How do we transition from search being the majority of revenues for Alphabet to moving towards AI, and what does that monetization path look like?

Casey McLean (13:39):

Well, yeah, AI does fundamentally change Alphabet's business model. And the way we would categorise the shift is they're moving from monetizing the click towards monetizing the answer, the action, and the experience. So, what do I mean by that? When you look at monetizing the answer, that's really about integrating ads into the AI responses, and importantly, these ads can be much more targeted, much more helpful than in the old traditional search era. So, if you think about an example like one I've done, why is my pool water green and what's the cheapest way to fix it?

(14:18):

If I did that in traditional search, I get a list of websites of pool supply companies and the like, which is great, but then I have to go in and do additional work. With the AI query, it's going to give me a step-by-step guide how to balance the tool, how to balance the chemicals, what I need to do, and then links to things like testing kits and the precise chemicals that you'd need to use as well. So, the information, the ads they're giving you are much more targeted, they're much more helpful and directly related to the problem that you have, so that more targeted leads to better monetization potential. The second one, monetizing the action, that's really about using AI to facilitate real-world actions.

(15:01):

So, if you think about in services, you might be looking to find a tradie, tradesperson to come and do a job for you. AI will be able to go out, find the tradie that can do the job, required that they're in your local area and has availability, and then it'll go out and book a time for them to come and directly integrate with the tradie's booking system. In return, they'll get a fee for lead generation that is paid by the business. If you think about goods, it's really about AI acting like a personal shopper. They're going to understand your unique needs, your preferences, and guide you on the discovery process with shopping, and then at the end, execute the transaction.

(15:42):

And again, take a small commission from the seller there as well. And then the final one, monetizing the experience. That's really the subscription model. It's about charging consumers and businesses, a monthly subscription to have access to their premium AI model as well. So, what you see in the AI era, really the future of monetization is more about having a diversified revenue mix. Advertising will still play an important role, still be a core component, but it's only going to be one of many components in potentially a much larger revenue pool.

Elisa Di Marco (16:18):

Yeah, that's a really exciting way to think about that. And when we think about companies more broadly, having that diversification in revenue and still high quality revenue is something that we very much appreciate within a business. I like the way you were describing how Alphabet's going to be able to monetize into the future and very much, it was centering around that more personalised agentic form of transaction, which is just very cool. If we can continue to automate how we work, how we run our households, how we shop, I think that that creates a lot of value and productivity for everyone that's using it.

(16:55):

Just reflecting back on one of the podcasts that we had earlier this year, we had Mark Nelson on, which was Visa's head of product, and he was talking through Visa's role in enabling agentic commerce. And since then, we've seen several announcements coming out from both Alphabet and ChatGPT on how they're pushing this technology forward. So, it seems like we're really on the cusp of that next wave of monetization and opportunity for Alphabet.

Casey McLean (17:18):

Yeah, absolutely. Yeah, we have seen a lot of announcements around this, and I think that agentic commerce is probably the nearest term, the next phase of the AI evolution and monetization potential. And I think it really represents a fundamental shift that away from this ad-based model to a commission-based model. And when you think about the opportunity there, it's a much larger opportunity set that is available, and it really represents a massive shift for Google from this passive information provider to being an active assistant, that's executing tangible tasks in the real world on your behalf.

(17:59):

And with the infrastructure that they have set up now, it's going to know you as well as anyone with all the links to your very services and able to execute those transactions to your needs and preferences better than anyone else as well.

Elisa Di Marco (18:14):

Yeah, I feel like the agent may know me better than me by the end of the next few years. Anyway, so when we're looking at investments, what we're very much focused on is the future and having that forward-looking lens of where we're seeing opportunity. So, when we are sitting at this juncture here of new technology, what indicators are you looking for that give you confidence that this is a technology that Alphabet's going to be able to transition through and enable versus it being a disruption event?

Casey McLean (18:45):

Well, you're right Elisa, every new technology, every big revolution like this is an opportunity and a risk depending on how you embrace the opportunity. And when we're thinking about Alphabet in particular, to gauge whether it's a successful transition or a real disruption event, I think we need to look at a few different areas to track their progress. I think the most critical one is the effective monetization of those AI answers that we talked about. And Google claims at the moment that they are monetizing the AI overviews at the same rate as their traditional searches, and that's despite that click-through rate being much lower.

(19:25):

So, that's really positive data point, and it'd be great to see more evidence of this coming through in their results coming up. The second I think is important to track really is advertiser adoption. It's great that users like AI and are getting a benefit from it, but advertisers need to see the value of it too. So, we want to see evidence that the new AI advertising tools that they've developed alongside AI overviews and AI mode, that these tools are leading to higher conversions and at the end of the day, a better return on investment for the advertisers as well. Thirdly, I think another thing Google has talked about is that AI will expand the market, expand the number of queries that are generated.

(20:09):

And we want to see evidence that this is actually happening. So, that means looking at things like total query volumes that should be growing. They have been structurally growing for the whole time Google's been in existence, but we want to see that trend continue in the AI era as well. And then finally, I think the thing we need to monitor as well is how well Google's managing costs and sustaining their margins. As you recall, we said AI queries, they're much more expensive than traditional, so we need to see evidence that they're mitigating managing this risk through innovation.

(20:43):

And the key way that they can do that is through progress, their custom AI chips, which lowers that cost of compute and also innovations and improvements around the efficiencies of the models themselves. So, therefore, the key things we're monitoring to ensure that this is an opportunity rather than a threat for Google.

Elisa Di Marco (21:03):

Yeah, absolutely. I suppose a nice dovetail from that is really the investment case then for Alphabet. So, we've talked a little bit about some of the opportunities in our discussion today, but could you bring it all together for us? Alphabet's still a core holding within our Magellan Global Fund and Magellan Global Opportunities Fund. Why is it still a buy?

Casey McLean (21:23):

It's a buy for four reasons. There's four key killers to the investment case for me. The first is that it is uniquely positioned, not only to navigate through this AI era, but really to lead in the next stage of AI. And that's through that unique combination of assets that we talked about earlier. The second is that AI is strengthening the core search business. You're contrary to this disruption narrative that AI is actually strengthening the monetization by these more targeted ads by converting the informational queries into commercial queries, and that's leading to stronger monetization in that core business.

(22:06):

Then linked to that is these massive new growth areas, growth opportunities that AI brings to Alphabet, and that's that potential to diversify away from advertising and into new revenue streams. And that has the potential to expand the company's TAM, their total addressable market, and with that sustained growth for the medium long term. And then the fourth one is the opportunity that they have in their other businesses outside of search. We haven't talked about them much today, but they do have some significant growth opportunities in these other businesses. Take YouTube, for example, we think that's still very much under monetized when you compare the monetization to their social media peers, or even the traditional linear TV as well.

(22:55):

And so, they have a good opportunity to grow their advertising, as well as subscription revenue for YouTube. The other one is the cloud business where they're growing really rapidly. They're catching up to the bigger players in terms of scale, and as a result, they're seeing margin improvement there as well. And the other one is Waymo, they're autonomous vehicles, robotaxi operation. Waymo is far and away the leading solution in the market today, operating today for robotaxis. And this is another potentially huge market opportunity, global market opportunity that Google is at the forefront as well. So, I think when you combine all those factors up, there's still a pretty promising future ahead for Alphabet.

Elisa Di Marco (23:37):

Yeah, absolutely. I think the breadth of what you were describing then of the Alphabet business and the billions of users that so many different parts of the business has, and then the untapped opportunity in Waymo is incredibly exciting. I hope that they announce that Sydney will be one of their cities that they want to roll Waymo out to in the near future, so that we'll get to experience how their journey is going. So, I suppose to close out today, Casey, can you bring it all together for us in that nutshell on how you describe what the future of search is?

Casey McLean (24:10):

Well, I think it's true that artificial intelligence is shaping the future of search. AI, it really is a revolution, not just for the economy and society, but for markets as well. And it's really going to create an opportunity for tremendous wealth creation for the winners. But at the same time, it's going to create some really big losers to companies that don't adapt and don't adopt AI technology as well. So, I think our job here at Magellan, it's really about doing that deep research, often assisted by AI to uncover the winners and at the same time avoid those losers, so ultimately we can generate wealth for our investors.

Host (24:53):

That was Magellan investment director and analyst, Elisa Di Marco, in conversation with portfolio manager, Casey McLean. We trust you've enjoyed this episode. For more information on previous episodes, visit magellaninvestmentpartners.com/podcast where you can also sign up to receive our regular investment insights programme. Thanks for listening.