ValueInvestor INSIGHT
The Leading Authority on Value Investing
September 30, 2025

Off the Rails?

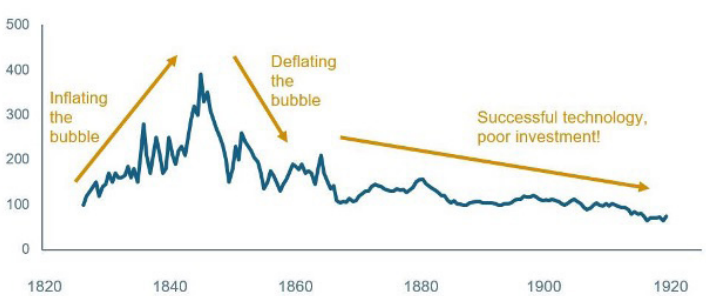
Venerable U.K. investment manager Hosking Partners takes a "capital cycle" approach to identify investment opportunity [*VII*, December 30, 2022]. The strategy rests on the notion that investors can put outsized emphasis on current or perceived demand for a company's product or service in setting its share price, neglecting the corresponding supply side of the equation. That disconnect can create mispricing as supply/demand dynamics shift as part of naturally recurring industry cycles.

So we read with interest "The AI Paradox: Capital Questions," a just-released missive from Hosking Partner and Portfolio Manager Django Davidson. The paradox, in summary, is that while large language models [LLMs] operated by firms such as OpenAI have "spawned the fastest-growing consumer product in history" and a "record-breaking capital boom," as Davidson puts it, "there is no clear evidence of how or when investors will see these businesses get anywhere close to profitability."

He draws an historical analogy with the railway boom in the U.K. during the mid-19th century, sparked by another revolutionary technology that many found potentially dangerous. As Davidson describes it:

> Despite extraordinary levels of growth in railway usage from the period of installation (9% passenger CAGR for decades), the boom saw capital catastrophically misallocated and competition far higher than anticipated. Actual cost per mile to build out the track proved to be 50% higher than projected. And actual revenue yields per mile fell far short of a projected 15% to just 3.3%. Share prices plummeted as shown in the chart below, despite society-wide adoption.

An Asylum of Railway Lunatics: British Railway Price Index



> Sensible questions about over-build were lost in the hullabaloo of the bubble. One question posted by this prologue is: if LLMs prove to be a 'winner takes all' industry, with one 'super intelligent' LLM model beating all the others, what would that mean for the (trillions?) of dollars deployed into the also-rans? The risk here would be a repeat of the 'dark fibre' of the 1990s telco boom, with LLM datacentres having to be repurposed, weighing on returns of the remaining cloud-compute hyperscalers.

He expects the AI paradox to present a challenge to what he calls the "current extreme market leadership," prominently evidenced by Nvidia having the largest index weight, 8%, of any company in the history of the S&P 500. Hosking Partners is taking the other side of this particular capital cycle:

> Whilst we cannot handicap the odds of potential winners of any AI superintelligence race, the declining ROIC of the hyperscalers taking part in this race are starting to weigh on their performance. Year-to-date the Magnificent 7 stocks are up just 12%, substantially underperforming old-economy sectors where returns are inflecting upwards, such as Banks (+26%) and Metals and Mining (+33%), both areas where the Hosking Partners portfolio is materially overweight the index.
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> All the investor attention that has been focused on the narrow set of U.S. mega-cap technology companies will likely migrate to areas where capital has been rationed and returns are starting to rise, not fall. This will likely focus on under-invested, asset-heavy areas of the market that have already weathered a downturn. Indeed, at Hosking Partners we are seeing our more idiosyncratic exposures – in small-to-mid cap, non-U.S. (in many cases emerging markets), and non-tech companies – driving strong absolute and relative year-to-date returns. These heretofore unfashionable companies are seeing ROIC improve at just the time the handful of stocks that have dominated markets for the last decade are seeing a reverse. The established market butterflies are turning into caterpillars – at just the same time as the caterpillars turn into butterflies. VII

Hosking Partners

Hosking Partners
11 Charles II Street
London, SW1Y 4QU
www.hoskingpartners.com

Contact:
Gwin Myerberg
Director, Client Service and Business Development
+44 (0)20 7004 7822
gmyerberg@hoskingpartners.com