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INSIGHT

TCW QUICK TAKE

AI Investment Potential Undeterred by DeepSeek News

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Markets reacted swiftly to news that DeepSeek, a Chinese AI lab, says it has developed a more efficient method of training and operating AI models that is a fraction of the cost of current frontier models. We are seeing a rapid unwinding of the AI trade, particularly among the core infrastructure providers due to perceptions that a more efficient training method will mean that less computing power will be needed.

Even with these new developments, AI is nowhere close to being "good enough" to reach its future potential and disrupt all industries. Indeed, this is not the first disruption for this megatrend and it won't be the last. **We believe the DeepSeek news is ultimately positive for AI and bullish as a demand driver.**

WHAT HAPPENED

DeepSeek, a Chinese AI lab that develops open-source large language models (LLMs), announced a more efficient AI model that is significantly lower cost to train and operate. The Chinese model, R1, is purportedly on par with leading frontier models in the U.S. but with significant improvements in capital efficiency. In essence, this means R1 can train AI models with less compute, which could translate into less demand for chips and electric power.

Despite this announcement, there is a lot we don't know about R1. While the numbers cited by the company on training costs are significantly lower compared with leading model costs, there are several questions about those figures. These include whether DeepSeek used leading edge GPUs, and if the model was trained with existing frontier models. There is still not enough clarity to answer those questions.

THE IMPLICATIONS

Since the beginning of the artificial intelligence megatrend, the principle means of improving the IQ of AI systems has been to make the models bigger, which requires more compute. Based on what has been reported regarding the DeepSeek model, there is no reason to believe that R1 itself wouldn't get more capable with more compute.

In essence, being more cost-efficient than ChatGPT today is not the end game.

The market is currently reacting negatively to the notion that the cost of providing AI technology is coming down. This has long been part of our investment thesis. We also believe that more efficient compute will drive even more demand due to higher return on investment (ROI). Through scaling, new architectures, or purpose-built

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models, we have long expected the cost of AI to fall over time. In fact, that's necessary for AI to reach into all sectors of the economy and disrupt industries in the ways we think it eventually will. Reducing the cost of AI means that it will be more appealing for companies that have been skeptical about its ROI. This will result in an acceleration of the AI megatrend.

We believe that the more productive the system is, the greater demand will be. If other LLMs replicate DeepSeek's training method, they are likely to experience similar price/performance benefits.For the hyperscalers and the companies looking to deploy AI in their business workflows, lower costs are unequivocally a good thing, and we do not believe their capital expenditure (CAPEX) plans for this year will change as a result of these headlines.

We believe the demand for infrastructure will continue even as new innovations bend the cost curve down. The more of those innovations we get, the better for the megatrend. The technology sector is littered with examples of falling unit prices leading to greatly expanding market sizes, and we expect AI will follow a similar path. The DeepSeek news has less to due with AI capability directly, and more about capital efficiency. The DeepSeek model itself doesn't move us any closer to artificial general intelligence, the pursuit of which is driving infrastructure investment.

CONCLUSION

It is clear that losers and winners will fluctuate amid AI developments. As active managers, we are focused on identifying the best AI companies – not all AI companies. We use a concept called "meaningful and measurable" to ensure our investments are realistically exposed to AI in a way that impacts the share price. "Meaningful" in that the effect of AI will be material to fundamentals, and "measurable" in that the effect can be quantified by the market.

Today's market reaction treats a breakthrough that may result in lower per-unit pricing as a negative development, while we believe the faster costs decline, the more demand there will be and the bigger the addressable market will be. Despite this potential increase in efficiency, we believe mid-term demand has been, and still is, underappreciated by the market. As such, we think the next estimate revisions are likely to still be up. ■

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