

Perspective from Templeton Global Investments

Global Equity Pulse

In focus: Software investing amid AI disruptions

Mixed performance among software-as-a-service (SaaS) companies calls for a closer look at how the artificial intelligence (AI) theme is playing out in the sector. While some companies are clear and long-term beneficiaries of AI tailwinds, others may be at risk of being disrupted or displaced by AI's fast-coding capabilities.

At Templeton Global Investments (TGI), we maintain our conviction in providers of business-critical enterprise software or systems of record (SORs) that are difficult to replace and hence are better positioned to harness AI-driven growth amid a rapidly evolving technology ecosystem.

Software: Why so soft?

The software sector, as represented by the MSCI World Software & Services Index, has slightly underperformed year to date (YTD), relative to both the broader technology benchmark MSCI ACWI Information Technology Index and the global benchmark MSCI ACWI Index.¹ (See Exhibit 1.)

More importantly, the still-decent Software & Services Index returns mask a high dispersion of stock performances. While the top three constituents in this index have seen very strong YTD gains, as of September 29, four of the top 10 constituents have actually declined over the same period.

Among the YTD sector underperformers are SaaS companies grappling with market concerns on the monetization and revenue growth of their AI tools; some are even perceived as outright AI losers that are at risk of being made obsolete in the global AI race.

These concerns have been given further airing in recent weeks. OpenAI Chief Executive Sam Altman argued in a social media post that the SaaS industry may soon enter a "fast-fashion" era. In broad terms, this concept suggests that the advancement of generative AI has enabled the wholesale creation and deployment of software tools at great speed and near-zero costs. It implies that corporate and individual users can quickly cycle through AI-generated low-cost disposable software tools, much like fast-fashion apparel.

In our view, these market chatters are not entirely new. Similar concerns were at play during the rise of open-source software in the late 1990s and early 2000s. As we remain invested in the software sector, we believe a bottom-up research and selection approach is as critical now as it was then. We believe the core thesis on AI as the single most-important growth driver across the information technology ecosystem remains just as valid for SaaS providers. The key is to differentiate potential AI winners from losers, identifying those that can weather near-term technological disruptions and capture long-term AI-driven growth through market leadership and durable customer propositions.

Core SORs more resilient vs AI disruption

Our current exposures aim to align with this view. TGI portfolios presently maintain core holdings in a small number of SaaS majors. Chief among them are providers of SORs that form the foundations for the key operations of a company. Think enterprise resource planning (ERP) or customer relationship management (CRM) systems housing mission-critical processes such as finance, human resources, supply chain, as well as sales and services.

Exhibit 1: Software Sector Performance Lagging YTD

	YTD Gross Returns (USD, %)
MSCI World Software & Services Index	13.88
MSCI ACWI Information Technology	14.10
MSCI ACWI	14.67

Source: MSCI. As of August 29, 2025. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.** See www.franklintempletondatasources.com for additional data provider information.

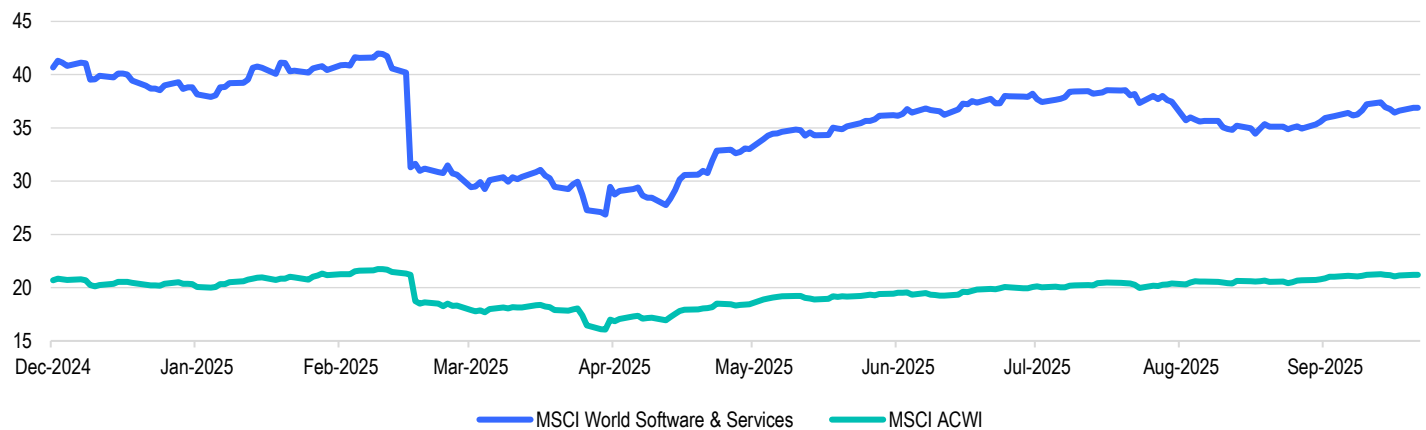
These essential enterprise SORs are relatively resilient to AI disruptions because they are built and customized to ensure absolute accuracy and robustness. For instance, an ERP system is expected to have zero errors in supporting the financial reporting and supply chain procurement of a large enterprise. We think this is a level of system excellence that simply cannot be replicated through AI-assisted vibe coding, despite Mr Altman's claim that the SaaS fast-fashion era is imminent.

In contrast, we believe AI is more likely to replace workflows with lower determinism; in other words, non-core functions where errors are more acceptable and enterprise-level customization is less expected. Software providers in this space may be more vulnerable to AI disruptions or competition from new AI entrants.² These are the types of potential AI losers that we wish to avoid.

As we stay selectively invested in the software sector, our bottom-up approach also entails consideration of stock valuations relative to the pace of growth for revenue or remaining performance obligation (RPO), a term referring to contracted but still unrealized revenue. While we are broadly confident of the long-term outlook for SOR providers, some are less compelling as they lack the revenue and sales growth trajectories to support their current valuations. We prefer the best-in-class names that offer visible and accelerating RPO or revenue growth, coupled with strong fundamentals, such as predictable earnings per share and free cash-flow growth over our investment horizon. Given the sector's still relatively high valuation (see Exhibit 2), prudence and patience are key. While the selected software companies within our research universe typically command a mid to high-teen-level of compounded annual growth rate (CAGR) for sales over the next five years, we may limit exposure to some of them at this stage, to wait for their AI-related business momentum to inflect and revenue growth to reaccelerate.

Exhibit 2: Software Sector Valuations Still Relatively Elevated

Price-to-Earnings Ratios (One-year forward): MSCI World Software & Services vs MSCI ACWI



Source: Bloomberg. As of September 30, 2025. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator of future results.**

To sum up, our team has not lost faith in the software sector but expects to remain selective toward SaaS companies amid market concerns of AI disruptions. We think core SOR providers could remain long-term winners, but attention to their valuations and revenue growth will continue to inform our bottom-up approach to the sector.

More broadly, we believe our prudence in the software sector dovetails with our core information technology holdings in hyperscalers and critical enablers in the semiconductor value chain. As a whole, these allocations constitute what we consider a diverse exposure to the most compelling potential growth opportunities driven by AI and digitalization trends.

Investment outlook

The US economy remains resilient and the US Federal Reserve (Fed) has resumed its policy easing cycle after a lengthy pause, creating positive macro conditions for risk assets, in our view. However, policy uncertainties remain a market overhang. We remain selective and underweight the US equity market, with financials and health care among our preferred sectors. In the Asia Pacific (APAC) region, we similarly maintain a bottom-up selective approach even as our outlook potentially improves. While not yet expensive, regional valuations have gained and risk/reward adjustments remain key. Potential venues for mispricing opportunities that we see include underappreciated non-AI technology companies in Taiwan, and South Korean stocks. In Europe, the combination of policy support, structural investment and attractive valuations underpin a constructive outlook. Market breadth is another key feature, offering a more diversified potential opportunity set across sectors such as luxury, health care, industrials and electrification technologies.

North America

US policy decisions have been erratic this year to say the least, and we expect this to continue. However, the economy appears to remain resilient, and the Fed is cutting interest rates in the middle of an economic expansion. Historically, such conditions have been bullish for risk assets.

The Trump Administration, supported by Republican majorities in Congress, has introduced various business-friendly deregulation and tax policies. Those policies are likely to underpin higher rising business investment, which typically foreshadows rising productivity and profitability. But there are negative developments: Tariffs are taxes, which may slow demand via lost purchasing power and compress profit margins. They reshore production, shifting and temporarily disrupting supply lines. It takes time and investment expense to onshore production so that it does not impair long-term profitability.

The US market to us is now all about stock picking, whereas previously an overweight to the country (and particularly to the US technology sector) almost guaranteed outperformance. We are content with our US underweight and encouraged by the attractive US stocks coming out of our research platform. Sectors of interest in the US include health care and financials.

The health care sector has suffered unprecedented underperformance in recent years, and trades on record low valuations, mostly due to negative Trump policies toward health care. Is this decline structural or has it thrown up some great opportunities at the stock level? We believe it is the latter. Strong fundamentals, especially cash flow generation, characterize our current holdings. In our view, these companies are better positioned for a market rebound when the sector moves past or digests this stretch of uncertainties.

APAC

With the Fed kicking off its policy easing cycle in the United States, Asian central banks—except the Bank of Japan—look likely to continue cutting rates in the coming months. Accommodative monetary conditions should be positive for APAC equities. The weakening of the US dollar may also prove accretive to regional corporates, which are already expected to see normalized earnings growth entering 2026. While we acknowledge the potentially improving macro backdrop, uncertainties remain, and near-term market volatility should not be ruled out. For instance, incessant US policy disruptions—such as the drug import tariffs announced on October 1—could remain a market overhang and may yet lead to downward earnings revisions. China's growth outlook also bears watching, and we will seek policy signals emerging from the five-year plan discussion later this month.

We believe our bottom-up focus on valuations relative to long-term fundamentals remains pertinent at this point in the market cycle. Notably, the MSCI AC Asia Pacific Index has gained nearly 20% so far this year, with our key equity markets of China, Taiwan, Hong Kong and South Korea all outperforming the global market significantly. In our view, these markets are by no means overpriced in terms of price-earnings ratios relative to the rest of the world, but the outperformance does call for careful risk/reward considerations. For instance, while we maintain ample Taiwan exposure to companies aligned with the AI theme, stock valuations may have become elevated due to market bullishness. We think it may make sense to gradually start looking at non-AI technology stocks that have lagged the sector rally, such as those in the consumer electronics and peripherals space.

Geographically, South Korea presents another venue for mispricing opportunities. In recent months, conscious regulatory efforts to ramp up the “Value-Up” program have continued, seeking to promote corporate governance reforms and shareholder value enhancement. This entails multiple rounds of commercial act amendments since July; in the fourth quarter, we will likely see new rules on mandatory cancellation of Treasury shares after buybacks. The potential narrowing of the so-called “Korean discount” will likely take time, but we think now is the opportune moment to broaden our current research and investment coverage in the country, which is mainly on banks and semiconductor companies.

Europe

Europe has long been associated with structural stagnation. Its share of global gross domestic product (GDP) has fallen from 35% in 1980 to around 15% today, reinforcing a narrative of relative underperformance. After the global financial crisis, the region faced a series of setbacks including sovereign debt turmoil, Brexit and an energy shock. Many indexes only surpassed pre-2008 peaks in 2020, leaving Europe often viewed as a tactical allocation rather than a growth engine.

That perception is starting to shift as policy responses have become more proactive, with fiscal measures, strategic investment and regulatory adjustments gaining momentum. Germany's €500 billion infrastructure plan represents a notable departure from its traditional fiscal stance, while the EU's €1 trillion defense commitment points to a more coordinated approach to security and industrial policy. Former Italian Prime Minister Mario Draghi's competitiveness report has also influenced reforms in capital markets, industrial

strategy and sustainability regulation, aiming to reduce compliance costs and encourage investment in energy, innovation and infrastructure.

These initiatives are beginning to shape expectations. EU GDP forecasts for 2025 have been revised upward, moving closer to the bloc's long-term average. If these trends persist, they could provide a more supportive backdrop for European equities. Nonetheless, valuations remain relatively low. Despite some recovery, European equities continue to trade at discounts to US peers and below their own 10-year averages.

Market breadth is another key feature of the current European equity landscape, providing scope for stock selection gains. Unlike the US market, where a handful of companies dominate, Europe offers a more diversified opportunity set across sectors such as luxury, health care, industrials and electrification technologies, which we view as ripe for stockpickers.

Market review: September 2025

Global equity markets advanced firmly in September 2025. The MSCI All Country World Index (ACWI) rose in USD terms, with growth stocks continuing to outpace value. Global sector performance was broadly positive, led by information technology and communication services; consumer staples, energy, and real estate were the only laggards.

Market performance in September was supported by a more accommodative stance from the US Fed, resilient corporate earnings, and renewed strength in technology shares. The US Fed's first rate cut of the year, trimming its target rate by 25 basis points to 4.00–4.25%, bolstered investor confidence amid signs of softening labor markets. The European Central Bank and the Bank of England, by contrast, left rates on hold, though the BoE slowed its pace of quantitative tightening. Meanwhile, the Bank of Japan maintained policy but took further steps toward normalization by preparing to unwind ETF holdings.

Endnotes

1. Source: MSCI. As of August 29, 2025. The MSCI World Software & Services Index is designed to capture the large and mid-cap segments across 23 developed markets (DM) countries. The MSCI ACWI captures large and mid-cap representation across 23 DM and 24 emerging markets (EM) countries. The MSCI ACWI Information Technology Index is a subset of the MSCI ACWI. All securities in the index are classified in the information technology sector as per the Global Industry Classification Standard (GICS®). Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses or sales charges. **Past performance is not an indicator or a guarantee of future results.**
2. Our view is informed by, among other sources, Bernstein's research on AI winners and losers in the software sector. Source: Bernstein, "Software: GenAI application winners/losers framework." As of April 7, 2025.

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All investments involve risks, including possible loss of principal.

Equity securities are subject to price fluctuation and possible loss of principal. **Small- and mid-cap stocks** involve greater risks and volatility than large-cap stocks. There can be no assurance that **multi-factor stock selection** process will enhance performance. Exposure to such investment factors may detract from performance in some market environments, perhaps for extended periods.

Active management does not ensure gains or protect against market declines.

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Investments in fast-growing industries like the **technology sector** (which historically has been volatile) could result in increased price fluctuation, especially over the short term, due to the rapid pace of product change and development and changes in government regulation of companies emphasizing scientific or technological advancement or regulatory approval for new drugs and medical instruments.

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