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FUND MANAGER INTERVIEW | NOV 11, 2026

How Causeway's $12bn quant has locked horns with AI risk

As the AI boom pulls unexpected industrial names into its orbit, Causeway Capital's Joe Gubler explains how combining quant models with human stockpickers is helping unearth hidden danger.

BY **ALGY HALL** IN LONDON

Warren Buffett's famous quip that 'only when the tide goes out do you realise you're swimming naked' feels particularly pertinent in light of last week's AI selloff. Many will have been left red-faced at discovering their exposure to the data-centre spending boom in seemingly distant corners of their portfolios.

'You're potentially not as diversified as you think you are if you're just looking at your sector allocations, because a lot of sectors have become correlated through AI,' said Joe Gubler, AA-rated portfolio manager on quant strategies with $12bn of assets, including Causeway Global Systematic UCITS, Causeway Emerging Markets fund and Causeway International Small Cap fund.

'As long as you know what risks you're taking, and you can do the risk-reward calculation on those things, you're in good shape as a portfolio manager,' he said. 'Where you're really in trouble is when you have risks that you didn't know about or that you didn't properly contain.'

Beta testing

To address the problem of quantifying AI risk, Gubler, a trained astrophysicist, collaborated with the fundamental investing team that works alongside Causeway's quants. The result is a blend of real-world observations combined with one of investing's classic volatility measures: beta.

'A new risk factor we developed a year or two ago we call the AI beta factor,' he said. 'We work with our fundamental colleagues to figure out a good index of stocks that represent the AI trade and the AI build-out… Then we can measure the sensitivity of every stock in our investable universe to that AI index. You essentially have the sensitivity of every stock to AI good news and AI bad news.

'[The] AI beta risk factor is super important because we can say what our overall exposure is to this theme… The active exposure that we have to it is about 0.1 standard deviations in a lot of the portfolios; higher than the benchmark, but not make-or-break.'

This has become increasingly useful as the AI trade has dragged an ever more unlikely cast into its orbit, including the likes of heavy construction equipment group Caterpillar (US:CAT), Italian cable maker Prysmian (IT:PRY), and copper miner Freeport-McMoRan (US:FCX), to name but a few left-field participants. All three companies have top Citywire Elite Companies AAA ratings, reflecting heavy backing by the world's best portfolio managers.

Real danger

The risks associated with AI go beyond the sensitivity of stocks to selloffs and rallies, though. The technology also presents the type of danger that the practically minded, such as Buffett, fear most: permanent capital loss.

For many companies, the threat of disastrous AI disruption is very real. Again, the starting point for quantifying this at Causeway has been collaboration with fundamental managers.

'We worked with them to come up with an eight-point scorecard, which basically looks at how much of your revenue could be eroded by AI over the next three to five years. Where do you sit in the value chain? What fraction of AI benefits can you capture? Are you susceptible to an AI-native entrant? Things like that,' Gubler said.

'The idea is that you score every stock one to five on those eight dimensions, and… come up with an AI disruption score.'

The difficulty with the exercise is the huge amount of effort required to scour all the documents from 2,400 companies in the investment universe to create a score for each. Gubler estimates it would take a human reading 24 hours a day about a year to get through everything. But these days, humans can be

spared such graft. Gubler's team has put AI on the job.

'It takes AI a day or two to run through that,' he said. 'And at the end of it, we have an AI disruption risk score for every stock in the universe… We're still going to go talk to our fundamental colleagues about it and see if they agree. The great thing about that is if we find out that the model got it wrong, we then come up with ideas for how to improve it.'

While its biggest funds are in the US, Causeway also runs several strategies that are available to buy in the UK and Europe, including Ucits versions of the Global Value and Emerging Markets strategies.

Texting

The to-and-fro between the fundamental and quant teams at Causeway has created systematic processes that have a qualitative feel.

'[It's] a glass-box process, not a black-box process, meaning we are looking inside the box and figuring out what we think the quant model can see and what we think maybe it is not fully processing,' Gubler said.

'You have "glass-box conversations" where you don't just say, "whatever comes out of the model, we do". We talk to our fundamental colleagues… We have that resource of discretion and editing.'

The nuance created by this interplay shows up, for example, in assessments of 'value' in the context of the individual characteristics of each company, its peer group, and its historical relative rating. Meanwhile, the different style factors the quant team scores, such as 'quality' or 'momentum', are given different weightings based on how relevant they are to given situations.

Trading in portfolios is also contextualised based on how much upside is expected from each dollar of turnover on any given day. Gubler thinks it likely that the recent selloff will trigger a noteworthy uptick in turnover in coming weeks.

Even before AI made text much more accessible to quants, Gubler and his team had factored the impact of certain corporate news into their model, and in the top-performing emerging markets fund, macro events account for a quarter of the overall stock scores. But AI creates the potential to do far more.

'As quants, we used to longingly look at all these broker research reports stacked up on our fundamental colleagues' desks and all this textual information you could learn things from,' Gubler said.

'We couldn't really use it because quant needs numbers. Well, suddenly with AI and LLMs, you can potentially turn all of this textual information into numbers that can be fed into a quant process.'

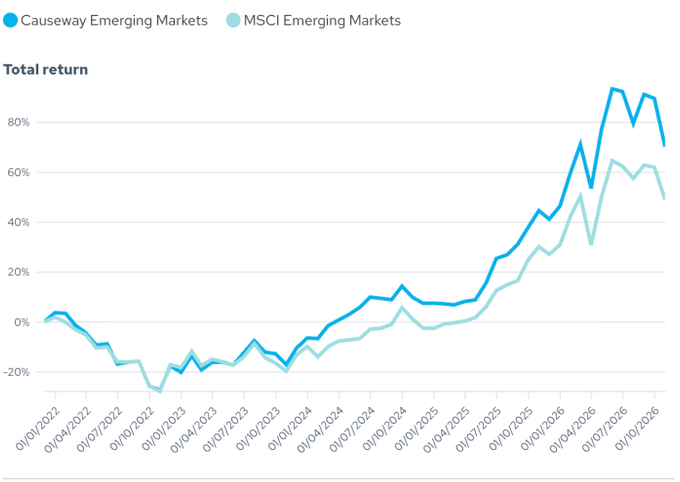
Gubler is doing a lot of work to figure out how text can best be used, what signals it can generate, and how it can improve existing processes. Already, AI is playing the role of devil's advocate in the stock selection process.

'If a new stock that we're not familiar with comes in, we generate an AI-driven investment thesis based on the available documents, and then we compare that to our quant thesis and look for gaps or disconnects… It doesn't mean that AI is right, but now it's a challenge.'

While AI may not be in the driving seat, it is providing more eyes on the road – which is useful, given it is also creating significant new bumps in it.

Causeway Emerging Markets is substantially ahead over recent years

5-year total return



Source: Morningstar • Acc B share class USD total returns

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