Market Insight

Who Loses in Creative Destruction?

How Avoiding Disruption Can Enhance Returns



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Everyone Wants to Find the Next Big Disrupter

Technological revolutions can create extraordinary wealth. Investors naturally focus on seeking to identify the next Amazon, Google, or Nvidia—the companies that emerge as dominant beneficiaries of transformative change. Entire industries have been built around predicting these leaders. Yet there is another side of innovation that often receives less initial attention: companies that will be disrupted. Both winners and losers are a result of what economist Joseph Schumpeter termed "creative destruction," which describes the economy's ability to grow even as it dismantles industries.

Identifying the beneficiaries of a technological revolution requires company-specific judgments about which innovators will execute successfully and capture an emerging opportunity. Vulnerable business models, by contrast, can often be identified at a broader industry level by understanding the nature of the innovation itself. As technology disrupts industries, changes in customer behavior, cost structures, and competitive dynamics can provide early warning signs of disruption. The businesses most at risk from these changes are often hiding in plain sight.

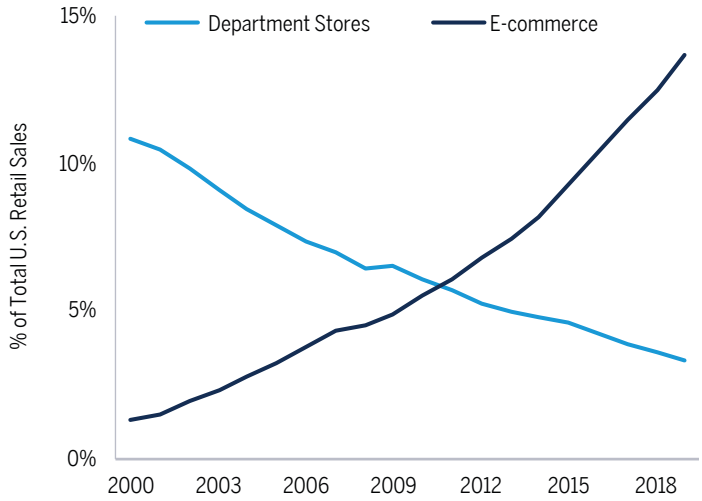
Passive investors may be more exposed to these future losers than they realize. Market-cap-weighted indices can be heavily invested in yesterday's winners and may only gradually gain exposure to tomorrow's champions. As a result, those who invest in strategies that closely follow benchmarks may enter periods of rapid innovation with substantial exposure to businesses susceptible to disruption.

Technological change is about destruction as well as creation. As a result, we believe that investors should devote as much attention to determining which businesses are most vulnerable to innovation as they do to identifying its ultimate beneficiaries.

The Easier Question: Who Will Lose?

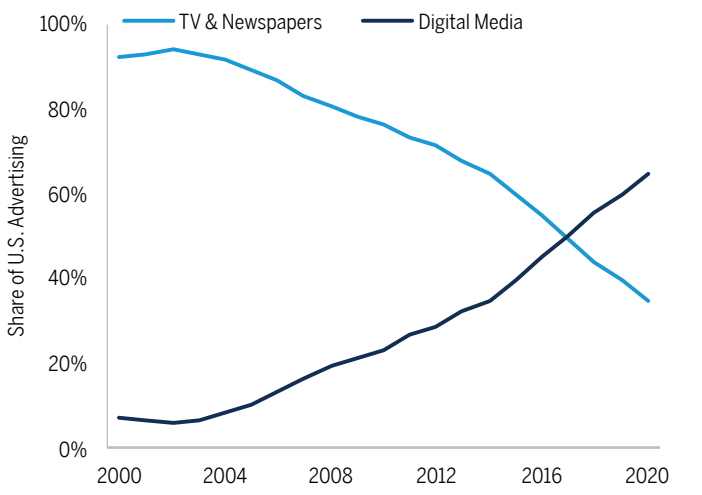
The investment community often focuses the discussion of rapid technological change on which companies will be the next great beneficiaries and gain large amounts of market share. That is, of course, a very important question. In our view, determining who will be the winners of innovation requires bottom-up, fundamental research and a specialized skill set. Diligent proprietary research including discussions with suppliers, customers, competitors, and other industry participants can illuminate the competitive positioning and economics of new products and services as well as how they could impact financial results.

Figure 1: **From Bricks to Clicks – The Retail Transformation**



Source: U.S. Census Bureau (2000 - 2019). Total U.S. Retail Sales excludes motor vehicles.

Figure 2: **Out With Old Media and In With The New Media**



Source: IAB PwC, Pew, Zenith. Total is comprised of TV, newspapers, and digital advertising.

Identifying losers might be easier because unlike winners, which typically must be determined one company at a time, many losers can be identified through a common business model that becomes structurally disadvantaged by technological change. A good example is retailing (see Figure 1). In our view, it became increasingly apparent that many department stores and specialty retailers would face mounting pressure as consumer spending migrated online. As e-commerce adoption accelerated, traditional retailers were burdened by high fixed costs, large real estate footprints, and labor-intensive operating models. Online retail offered generally higher returns on capital and greater convenience for consumers. While predicting the emerging leaders required company-specific analysis, the direction of disruption was more immediately clear and its trend was long-lasting. Amazon ultimately proved more successful in e-commerce than eBay, while Walmart eventually adapted more effectively to online retail than Target, but it was the broader trend of the decline in department store retail sales and the significant increase in e-commerce sales that had broader investment implications.

The same pattern emerged in media (see Figure 2). Company-specific research may have helped investors assess whether Google, Yahoo, AOL, or another internet company would become the dominant digital advertising platform. However, the vulnerability of newspapers, classified advertising, and television became increasingly visible as consumers spent a larger share of their time online, driven by the explosion in the volume and variety of digital content. Digital advertising also offered more precise audience targeting, measurable returns on investment, and real-time campaign optimization, further reinforcing the migration of advertising spending online. The structural disadvantage that led to the long-term decline for traditional media businesses was clear.

Across both retail and media, the same pattern emerged: technological disruption created opportunities for new leaders while revealing vulnerable incumbent business models. In our view, discussions of disruption frequently emphasize the former despite the importance of the latter.

Passive Investing Problems

Disruption can hit passive investors or those that closely track benchmarks particularly hard. The problem is the result of market-cap-weighted indices allocating capital based on current size rather than future opportunity. The market size of a company is often based on recent results because shorthand valuation metrics, such as price-to-earnings multiples, typically figure prominently in the broad market assessment of equities. Consequently, incumbents usually begin disruption cycles as large index weights while disruptors often begin as small weights, leaving passive investors with substantially greater exposure to legacy business models than to emerging alternatives. Many future winners may still even be private companies.

Figure 3: **S&P 500 Exposure to Incumbent vs. Disruptive Business Models**

	2005	2010	2015	2020	2025
Disrupted: Physical Retail	5.0%	4.6%	4.9%	3.7%	2.9%
Disrupters: E-Commerce	0.6%	0.8%	1.6%	4.6%	3.9%
Disrupted/Disrupters	**8.9x**	**5.4x**	**3.0x**	**0.8x**	**0.7x**
Disrupted: Legacy Media	3.4%	3.2%	3.3%	2.4%	0.8%
Disrupters: New Media	0.4%	1.6%	4.3%	6.2%	9.1%
Disrupted/Disrupters	**7.7x**	**2.0x**	**0.8x**	**0.4x**	**0.1x**

Source: FactSet and Alger. The categories are custom groupings based on their economic exposure and may differ from standard index provider classifications. Physical Retail includes retailers whose primary business is from brick & mortar stores as well as retail real estate businesses. E-Commerce includes online retail and marketplace platforms. Legacy Media includes newspapers, publishing, broadcast, cable, and radio companies. New Media includes online advertising, social media, and streaming platforms.

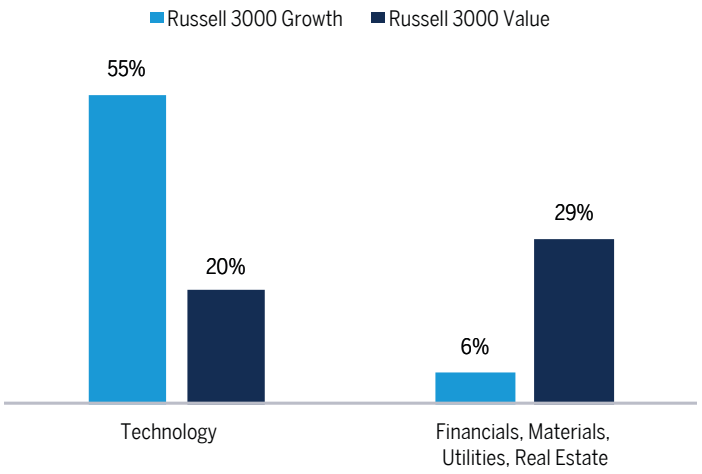
Empirical evidence of this imbalance over the past two decades supports this view (see Figure 3). In 2005, physical retail-related companies, including department stores, apparel retailers, electronics retailers, and mall real estate owners, accounted for roughly nine times the S&P 500 weight of e-commerce companies. By 2020, the relationship had reversed, with e-commerce representing a larger weighting in the index. Similarly, legacy media companies, including newspapers, broadcast television, and cable companies, had nearly eight times the index weight of new media companies in 2005. By 2025, the situation had flipped, as new media companies had grown to dwarf legacy media, whose index weight had declined by more than 75%.

The Value Trap

The risk of over-allocating to companies that will be disrupted is even higher in value style indices, in our opinion. Traditional style benchmarks, such as the Russell indices, use metrics that cause more innovative companies to be classified as growth companies and many mature or slower-growing companies to be classified as value companies. For example, the price-to-book ratio figures prominently in Russell's classification methodology. Companies with lower market value to book, or net asset value, are more likely to be included in the value index. These companies have less of their market capitalization attributable to intangible assets that do not show up on the balance sheet such as patents, trade secrets, or copyrights. Because innovation is often missing from financial statements, and particularly the balance sheet, traditional metrics based on those accounting conventions skew toward companies whose value is derived more from existing assets like property, plant, and equipment rather than research & development, which can potentially generate more dynamic growth.

This innovation gap can be seen in the sector exposure of the style indices (see Figure 4). As shown in the chart, the Russell 3000 Growth index has a much higher weighting to the technology sector, while the

Figure 4: **Growth vs. Value or Disrupters vs. Disrupted?**

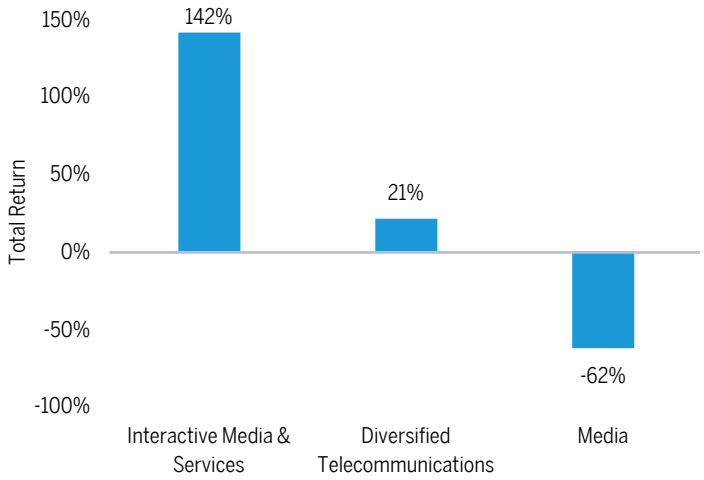


Source: FactSet, sector weightings as of 9/30/26.

Russell 3000 Value has a larger weighting to the financial, materials, utilities, and real estate sectors. This difference in exposure is one reason why the Russell 3000 Growth has returned 13.1% vs. 8.5% for the Russell 3000 Value over the past 20 years (as of 9/30/26). While that 460bps growth outperformance may seem modest, the compounding impact is enormous. A $100,000 investment in the growth index would have returned $1.2 million, while only growing to $0.5 million in the value index over that same time period. This dramatic difference in wealth accumulation highlights the long-term cost of allocating capital to businesses on the losing side of technological change.

The Communication Services sector is an interesting example of the split between innovators and traditional companies along the growth and value classification. In the Russell 3000 Growth index, the majority of the sector is comprised of companies within the dynamic Interactive Media & Services Industry, primarily Alphabet and Meta. However, in the Russell 3000 Value index, more than half of the sector weighting is in traditional telecommunication and media companies (e.g. AT&T and News Corp). The difference in performance between these two groups of companies has been striking. Over the past five years, the Interactive Media & Services Industry returned 142% as compared to only 21% for the Diversified Telecommunications Industry and a woeful -62% for the Media Industry (see Figure 5).

Figure 5: **Growth Dramatically Outperformed Value-Oriented Industries**



Source: FactSet, industry returns in the S&P for the five-year period ended 9/30/26. **The performance data quoted represents past performance, which is not an indication or a guarantee of future results**.

Why Visible Losers Stay Mispriced

If value destruction is predictable as a result of new technology, why doesn't the equity market quickly price it in? We believe that there are two reasons that eventual losers of innovation stay overvalued for extended periods of time:

1. ***The Growth Projection Bias.*** The market tends to assume that companies will continue growing, even when technological disruption begins to hurt their competitive position. Analysts often follow management guidance closely and executives rarely forecast their own decline. Instead, they typically emphasize new initiatives, product launches, or cost reductions that are expected to restore earnings growth. Analysts often want to believe these narratives and may be reluctant to model severe deterioration until there is overwhelming evidence that it is occurring. As a result, earnings estimates can remain too high for too long. This is particularly problematic during periods of disruptive innovation, when new technologies can rapidly change consumer behavior and industry economics. Despite margin compression, declining revenue, and weakening competitive advantage, consensus forecasts may continue to anticipate stabilization and an eventual return to growth. By the time expectations fully reflect the new reality, a substantial amount of value destruction may have already occurred.
2. ***The Value Trap Phenomenon.*** Investors are often attracted to stocks that look inexpensive relative to their own history or the broader market even when their fundamentals are under pressure and at risk of further erosion. A stock trading at low-double-digit or high-single-digit price-to-earnings multiple screens well for many investors and can look like a bargain. Yet in many disrupted industries, the fundamentals decline faster than expected and the valuation multiple remains low such that the stocks continue to decline. For example, S&P 500 department stores traded at a modest P/E of 12.1x at the end of 1999, a massive 50% discount to the S&P 500. Despite the attractive valuation which persisted over the next two decades, department store stocks fell 4% through 2019 while the S&P

500 rose 120%. The conclusion, in our view, is that businesses facing technological obsolescence can appear persistently cheap throughout their descent, luring investors into positions that ultimately prove far less valuable than traditional valuation metrics would suggest. The risk is not limited to dramatic losses or bankruptcies. Simply earning too little for too long can be just as costly.

Disruption due to Artificial Intelligence

Most current discussions of artificial intelligence (AI) focus on the infrastructure beneficiaries, including semiconductor designers and manufacturers, cooling and power providers, networking companies, cloud platforms, power generation, and large language model providers. These may indeed become enormous winners as consumers and businesses reap the productivity benefits of this technology.

However, history suggests investors should devote equal attention to understanding the other side of this potential productivity boom: which industries will see their ability to create value ultimately commoditized by AI? The explosion in output that AI will generate is likely to reduce the competitive advantages of many businesses and therefore destroy a huge amount of shareholder value.

Potentially vulnerable business models may include those built around routine information gathering, administrative complexity, and basic content creation. Just as e-commerce challenged physical retail and digital media disrupted traditional publishing, AI may challenge industries whose economics depend on information scarcity or labor-intensive white-collar processes.

We believe that AI will drive a dramatic decline in the cost of creation. Tasks that once required large teams, specialized expertise, and months or years of development can increasingly be completed by far fewer people in a fraction of the time. As the cost and time required to create products and services declines, barriers to entry may fall as well. When creation becomes cheaper, competition tends to increase, placing pressure on incumbent profit pools and established business models, in our view.

Seen through this lens, industries built around delivering knowledge work may be especially at risk. Advertising agencies, IT consulting firms, enterprise software, business process outsourcing providers, insurance brokers, and certain information services businesses have historically benefited from the cost, expertise, and time required to produce content, code, analysis, research, and administrative output. As AI reduces those requirements, these industries may face increasing competition and pressure on their profits and stock prices.

Finding Opportunities, Avoiding Disruption

Every technological revolution generates wealth creation as well as value destruction. While investors devote most of their time and resources to identifying the beneficiaries of innovation, we believe equal attention should be paid to understanding which business models may be vulnerable to it.

Emerging companies with new competitive advantages, lower cost structures, and more enticing products or services attract investor funds. Investment leaves those industries and corporations that cannot keep up with the changing business landscape. While the overall economy may grow, many companies will lose and, in the process, they will either destroy shareholder value or generate inadequate returns for years.

This dynamic has important implications in an era increasingly dominated by passive investing. Because market-cap-weighted indices allocate capital based on current size and scale, investors may have meaningful exposure to businesses facing long-term disruption.

The key question is whether technological change is beginning to undermine the foundations on which an industry's profits depend. Historically, those foundations included store networks and physical distribution in retail, as well as static advertising inventory in media. In the era of AI, pressure may fall on industries whose economics depend on labor-intensive processes, administrative complexity, or high creation costs.

We believe understanding where value is likely to be destroyed or gradually eroded can be as important as understanding where value is likely to be created. To avoid disruption and enhance returns, investors may want to seek out active managers who understand innovation cycles. These cycles can significantly change company fundamentals, decimating incumbents, and anointing new leaders. Investors who recognize both sides of creative destruction may be best positioned to navigate the coming technological revolution.

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