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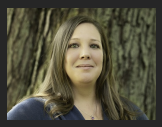
Expanding Investment Horizons: Diversification Opportunities Beyond Major Indices



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May 28, 2025

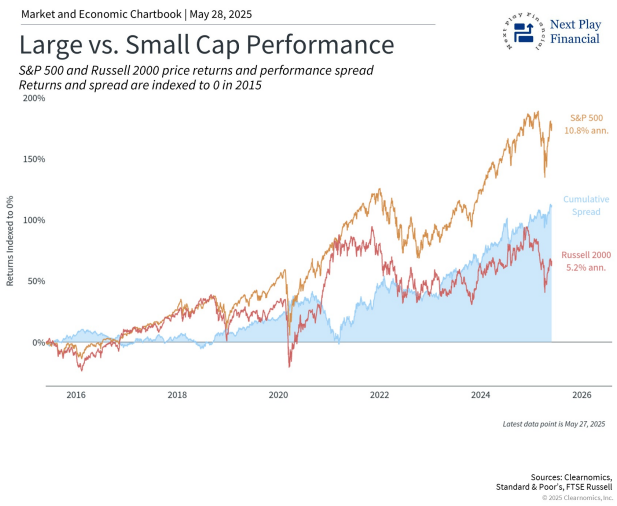
Equities serve as a cornerstone for building long-term investment portfolios. As components of well-rounded financial strategies, stocks have traditionally generated wealth and supported investors in reaching their financial objectives. Yet an important consideration emerges: which types of equities should be included? While investment professionals and financial media often concentrate on shares of the largest corporations, numerous other categories can serve vital functions within diversified investment approaches.

Market performance is frequently associated with major indices like the S&P 500 or Dow Jones Industrial Average. The S&P 500 represents an index monitoring the performance of 500 of the largest publicly traded corporations, organized by market capitalization as a measurement of company scale. The Dow encompasses just 30 large, established enterprises. Both indices predominantly feature companies that are incorporated and based in the United States.

Given their construction methodology, these benchmarks concentrate solely on America's largest corporations. This approach proves valuable for gauging overall market and economic trends, as the biggest companies typically drive these patterns. Nevertheless, when constructing investment portfolios, these indices might miss other promising opportunities. This becomes particularly significant when a small number of "mega cap" stocks, including members of the Magnificent 7, have been the main contributors to both gains and losses.

Within the current market climate, how might investors expand their investment scope? Smaller company stocks and global markets represent two areas that can offer opportunities and portfolio diversification. Both provide unique characteristics and potential advantages that can strengthen portfolio diversification, particularly during periods of market instability and economic uncertainty.

Smaller companies have underperformed but provide diversification advantages



Smaller company stocks encompass businesses with market capitalizations generally spanning from several hundred million to a few billion dollars. This differs from mid and large-cap enterprises that range from tens to hundreds of billions, and mega caps which are currently valued in the trillions.

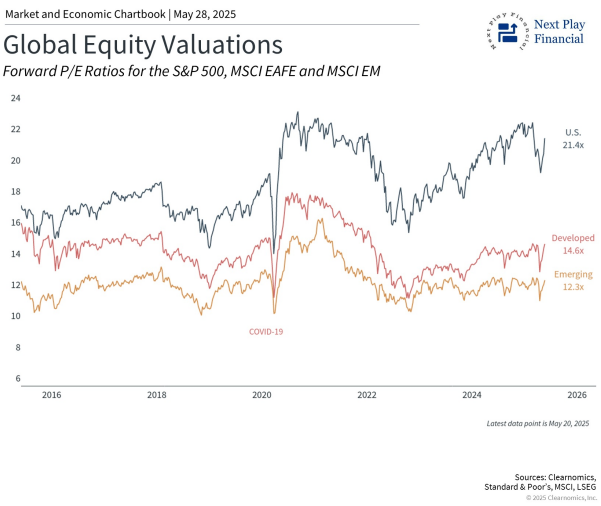
The Russell 2000 index, which monitors small-cap performance, has produced 5.0% annualized returns during the past decade versus 10.5% for the S&P 500, as illustrated in the accompanying chart.[1] This performance differential has been especially notable in recent years as market concentration among large and mega cap companies has grown, particularly within technology and artificial intelligence-focused sectors. Smaller companies generally have reduced exposure to the technology sector and generate more revenue from domestic operations, making them responsive to shifts in U.S. economic policy and trade circumstances.

Importantly, small caps have faced challenges this year amid continuing uncertainty regarding tariffs and economic expansion. Nevertheless, this has resulted in potentially appealing valuations. Smaller company stocks are presently trading at more reasonable price-to-earnings ratios relative to large-cap stocks. The Russell 2000 currently maintains a price-to-earnings ratio significantly below its 10-year average. Even more notable is the price-to-book value of approximately 0.8x, substantially lower than the historical average of 1.2x. By contrast, many of the S&P 500's valuation measures are well above average, if not approaching all-time peaks.

The interest rate landscape represents another significant distinction between large and small-cap companies. Smaller caps frequently depend more extensively on financing through floating rate debt compared to their large-cap peers, making them more vulnerable to interest rate changes. Although this presented obstacles when interest rates increased rapidly starting in 2022, the more stable environment since could be beneficial. This is particularly true if the Fed proceeds with rate cuts later this year.

Many of these indicators suggest that smaller company stocks are more attractively priced than many other market segments. While large caps will remain crucial components of many portfolios, this emphasizes that opportunities exist throughout various market sectors.

Global markets remain attractively priced



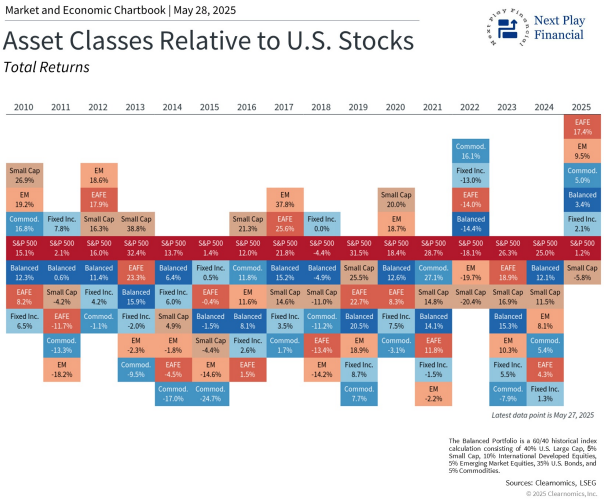
Another sector with appealing valuations is international equities, which are commonly divided into two primary categories: developed markets (including Europe, Japan, and Australia) and emerging markets (featuring countries such as China, India, and Brazil). These distinctions reflect variations in economic development, market structure, regulatory environments, and additional factors.

While U.S. equities have dominated global markets throughout much of the previous decade, international stocks have outperformed this year. Particularly, the MSCI EAFE index, which follows 21 major developed market nations, has increased approximately 17.5% year-to-date in U.S. dollar terms. The MSCI EM index, which tracks emerging markets, has climbed 10%.[2] This has happened despite global uncertainty related to trade.

Beyond these markets performing better this year, valuation gaps remain significant. While the S&P 500 trades at elevated price-to-earnings ratios, international markets present more attractive valuations, as demonstrated in the chart above. This is partially attributed to political and economic difficulties in many of these regions over the past decade, some of which have started to improve.

One important distinction between U.S. and international investing is that currency movements can impact returns. Specifically, the weaker dollar has established favorable circumstances for U.S.-based investors. This occurs because foreign assets appreciate in value when the currencies they are priced in strengthen, enabling them to be exchanged back for more dollars. This currency benefit has been a significant contributor to the robust performance of international stocks this year, providing an extra boost beyond the fundamental performance of foreign companies.

Diversification across regions and company sizes remains crucial



For investors with long-term horizons, maintaining exposure to sectors such as small-cap and international stocks can help establish more balanced portfolios. This is particularly relevant following the substantial performance of large-cap stocks which have been powered by just a small number of the largest companies.

This does not suggest that U.S. large caps will diminish in importance. This is also not a recommendation for making substantial modifications to well-designed portfolios. Rather, maintaining long-term portfolios involves holding appropriate asset allocation across all these investment

types. By incorporating more attractively valued market segments, we can potentially enhance long-term risk-adjusted results and capitalize on market opportunities. While any individual asset class may lag during specific periods, their distinct characteristics and return behaviors can deliver valuable diversification benefits over time.

The bottom line? Although the S&P 500 and Dow continue to serve as significant benchmarks, investors should evaluate the advantages of diversifying across numerous other market segments, including smaller enterprises and international equities. Maintaining suitable portfolios for the long term remains the optimal approach to achieving financial success.

1. Russell 2000 and S&P 500, price returns, from January 2, 2015 to May 23, 2025
2. MSCI EAFE and MSCI EM, total returns, January 1, 2025 to May 23, 2025

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