

3/26/2024

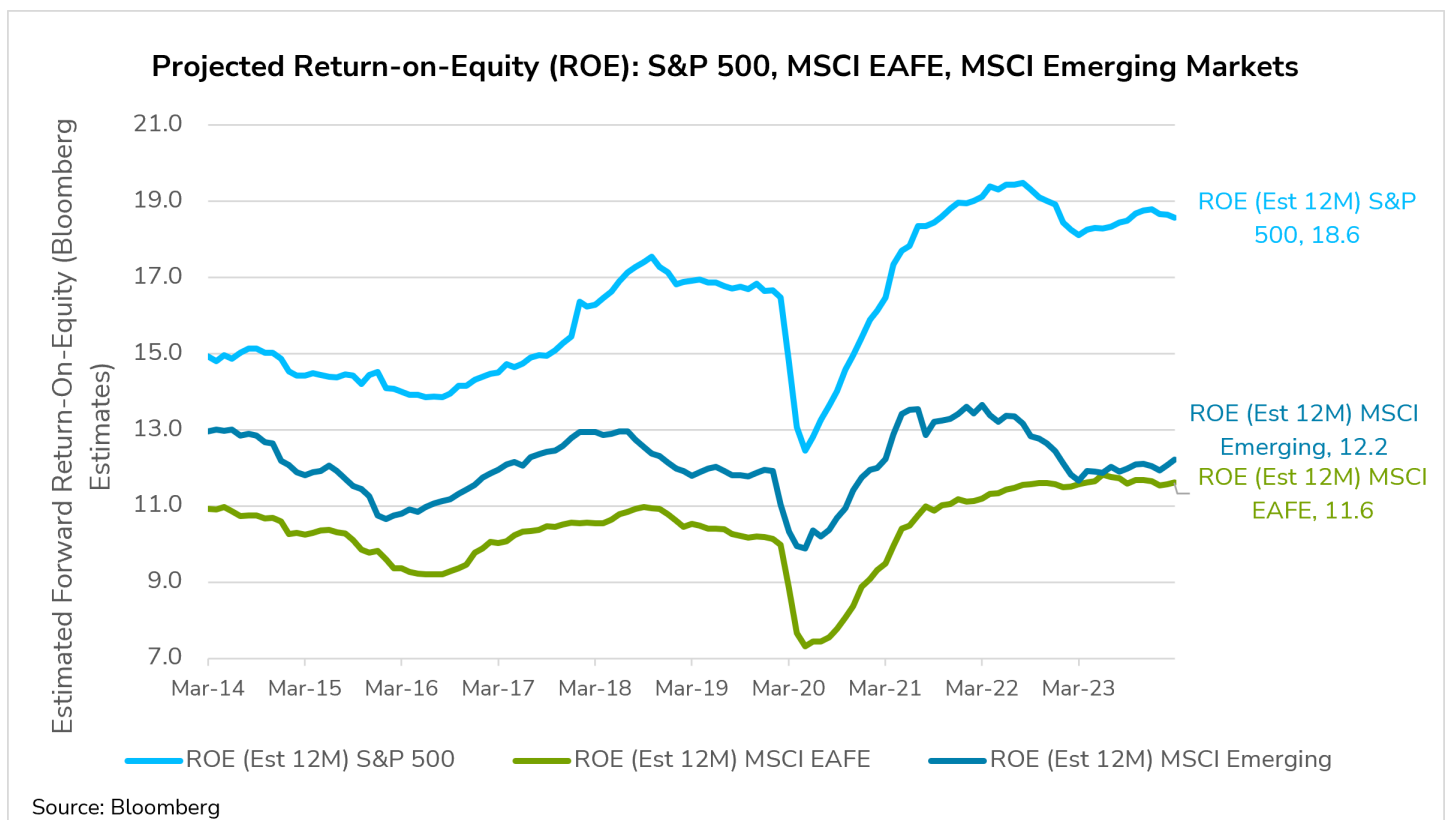
**Summary:** It is understandable that U.S. investors want to maintain a home bias given strong outperformance and higher profitability of U.S. large caps. But there are growing concentration and valuation risks with maintaining a U.S. home bias which can be mitigated by expanding the home-front and investing beyond the concentrated U.S. large cap indices.

1. U.S. Large Cap Stocks, as proxied by the S&P 500, have outperformed world markets since the bottom of the 2008-09 Great Financial Crisis through 2/29/2024.
  - The cap-weighted S&P 500 Index has generated a total annualized return of 16.0% versus 8.6% for ex-U.S. developed markets (MSCI EAFE Index) and 7.4% for global emerging markets (MSCI EM Index).
  - Despite the recent dominant performance of the largest stocks within the S&P 500, the S&P 500 Equal Weight Index remains ahead of the cap-weighted index, returning 16.4% annualized over this period.

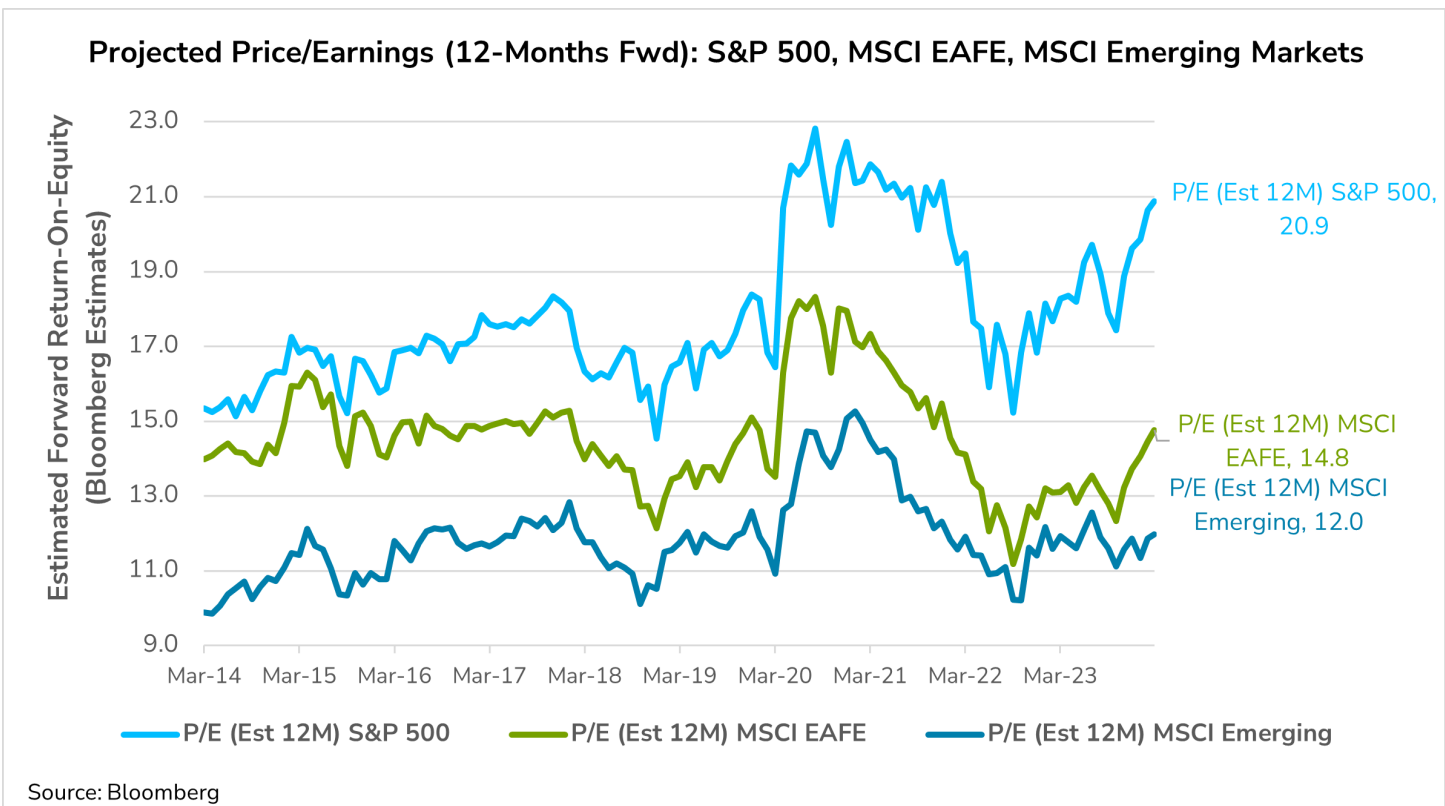


Source: Bloomberg

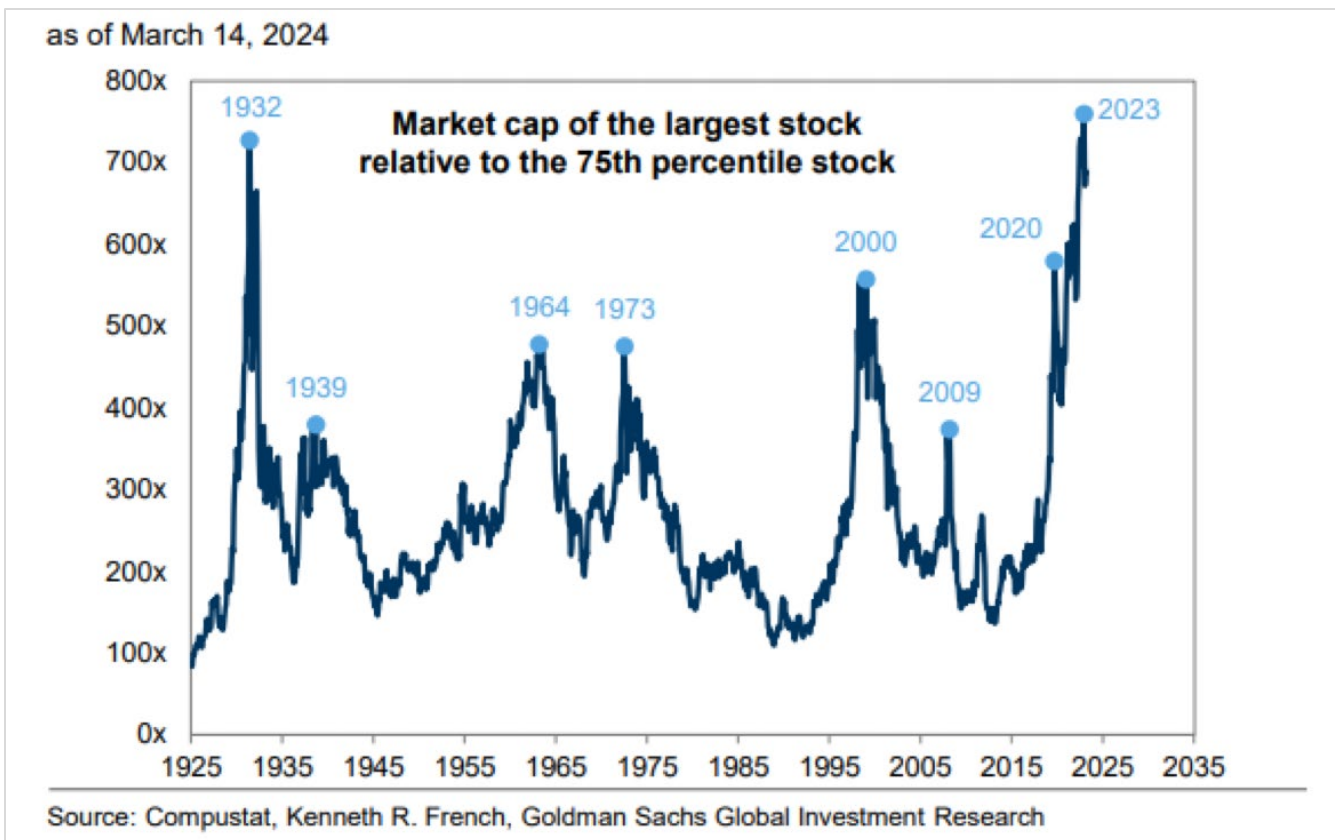
2. The outperformance of U.S. stocks over the rest of the world for the last 15-year period can be explained by the widened profitability gap (return-on-equity or ROE) of U.S.-based companies versus their international peers.
  - The S&P 500's projected return-on-equity ("ROE") of 18.6% (as of 3/26/2024) remains well above the projected ROE of 12.2% for MSCI Emerging Markets and 11.6% for MSCI EAFE.
  - U.S. companies have consistently generated higher ROE over the past 10 years and that gap has only widened over the post-pandemic period.
  - This profitability gap shows few signs of mean reversion as the U.S. market has comprised a greater share of high growth and more profitable technology and consumer companies.



3. With a diverse and highly profitable market to invest in, it is understandable why many U.S. investors maintain a U.S. home bias in their equity programs. Yet, relative valuations, as measured by price/earnings multiples, have also widened between the U.S. and the rest of the world commensurate with the widening gap in profitability.
  - The S&P 500 trades near 21x estimated next 12-month earnings (NTM), close to a 10-year high, versus 14.8x P/E for MSCI EAFE and 12.0x P/E for MSCI Emerging Markets.
  - The U.S. home bias is becoming more expensive to maintain as U.S. investors increasingly are having to pay up to invest in the best house in the global neighborhood as measured by profitability and growth potential.



4. Investing in the S&P 500 also translates into investing across a narrower, more concentrated market, dominated by a handful of companies and industries.
  - The post-pandemic period has witnessed an increased concentration of market value assigned to a handful of mega-cap companies as the valuation gap between the largest companies relative to the rest of the market has grown to levels not seen since the Great Depression.



5. With the cap-weighted S&P 500 trading near cycle-peak valuations and a level of concentration that exceeds even that of the late 1990s Dot-Com Bubble, investors who want to maintain a U.S. home bias in their equity program should explore other opportunities across the U.S. market.
  - The S&P 500 Equal Weight Index, a proxy for the rest of the U.S. market, has traded at a sizeable valuation discount to the cap-weighted S&P 500 for much of the post-pandemic period. The two indices traded at much narrower valuation spreads pre-pandemic.
  - The profitability gap has also widened between the cap-weighted S&P 500 versus the equal-weighted version over the post-pandemic period. One could argue that this profitability gap will remain structural and less subject to mean reversion due to scale and competitiveness of the largest companies to maintain their dominant market share and innovation. However, this current profitability gap could be viewed as abnormal, subject to mean-reverting competitive forces.

**Projected Price/Earnings (12-Months Fwd): S&P 500 Cap-Wgt vs S&P 500 Equal-Wgt**



Source: Bloomberg

**Projected Return-on-Equity (ROE): S&P 500 Cap-Wgt vs S&P 500 Equal-Wgt**



Source: Bloomberg

6. In hindsight, investors would have been well-served not only to be exclusively invested in the U.S. home market but solely within the largest and most profitable companies. We believe a broader breadth of investment opportunities exist even within the U.S. home market, where investors need not sacrifice quality for more market diversity and less expensive valuations. Here are some strategies available on our platform to consider:
- U.S. factor-tilted model portfolios to risk premiums historically rewarded by the market over the long run, offered by Freedom Investment Management, including 3D, Dimensional, Avantis, BlackRock, Alpha Quant, and Symmetry Partners.
  - Sector allocation models such as Lee Adaptive Large Cap Sector and NDR Sector Allocator to diversify away sector concentration risk embedded in the S&P 500 Index.
  - Separately managed accounts (SMAs) investing in stocks beyond U.S. mega-caps, particularly ones that invest in higher quality companies such as Eagle Ridge Global Quality and Zacks All Cap Core.

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MT-519226