

Smart diversification in an age of U.S. exceptionalism



From the Field

Key Insights

- **Valuations are stretched:** While U.S. large-cap stocks significantly outperformed other equity assets in 2024, the performance outpaced earnings growth and contributed to stretched valuations.
- **Diversification has fallen:** U.S. exceptionalism took hold as the outperformance of U.S. large-caps and relatively narrow market leadership contributed to a U.S. bias in model portfolios.
- **Now is not the time to abandon diversification:** Coupled with favorable valuations, a convergence in earnings growth over the coming years could lead to opportunities outside of U.S. large-caps.
- **Smart diversification in portfolio construction:** A smart approach to diversification looks ahead and anticipates future expectations to help advisors reposition client portfolios.



Terry Davis

Director of Investment Solutions, Portfolio Construction Solutions



Nate Pfeiffer, CFA®

Director of Investment Solutions, Portfolio Construction Solutions

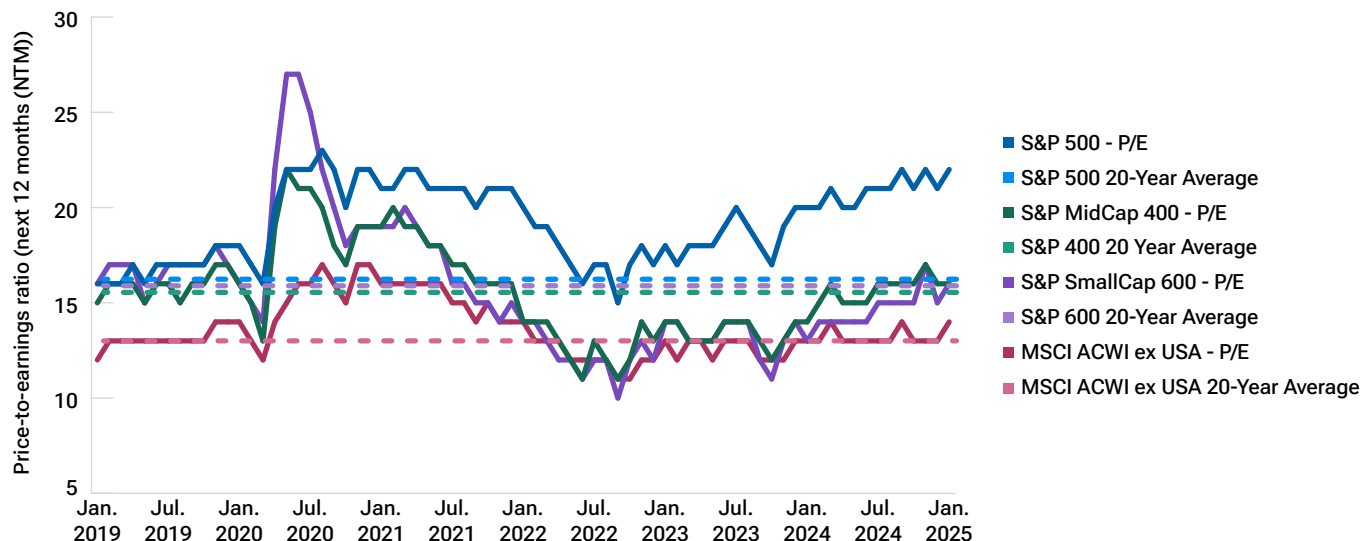
The S&P 500 Index of U.S. large-cap stocks gained approximately 25% in 2024. At the same time, U.S. small-cap stocks (Russell 2000 Index) rose 12% and international stocks (MSCI All Country World Index ex USA (MSCI ACWI ex USA)) returned just under 6%. While the significant outperformance of U.S. large-cap stocks in 2024 was impressive, earnings growth failed to keep pace, which contributed to stretched valuations.

As shown in Figure 1, U.S. large-caps traded at a premium compared with long-term averages using forward price-to-earnings (P/E) ratio, while U.S. small- and mid-caps (SMIDs) and international stocks were priced largely in line with their historical averages.

Looking at Figure 2, U.S. large-cap growth and U.S. mid-cap growth both traded at a premium to their long-term averages, unlike comparable value-oriented stocks.

Valuations for U.S. large-cap stocks appear stretched compared with other equities

(Fig. 1) Forward P/E valuations: U.S. large-caps versus SMIDs and international stocks



Sources: Standard & Poor's, MSCI via FactSet data and analytics. See Additional Disclosures.

Diversification has fallen in advisor portfolios...

The allure of U.S. exceptionalism can be hard to resist. The U.S. enjoys many distinct advantages over the rest of the world: deep and liquid markets, a stable and predictable regulatory environment, a dynamic economy, and the status of the U.S. dollar as the global reserve currency.

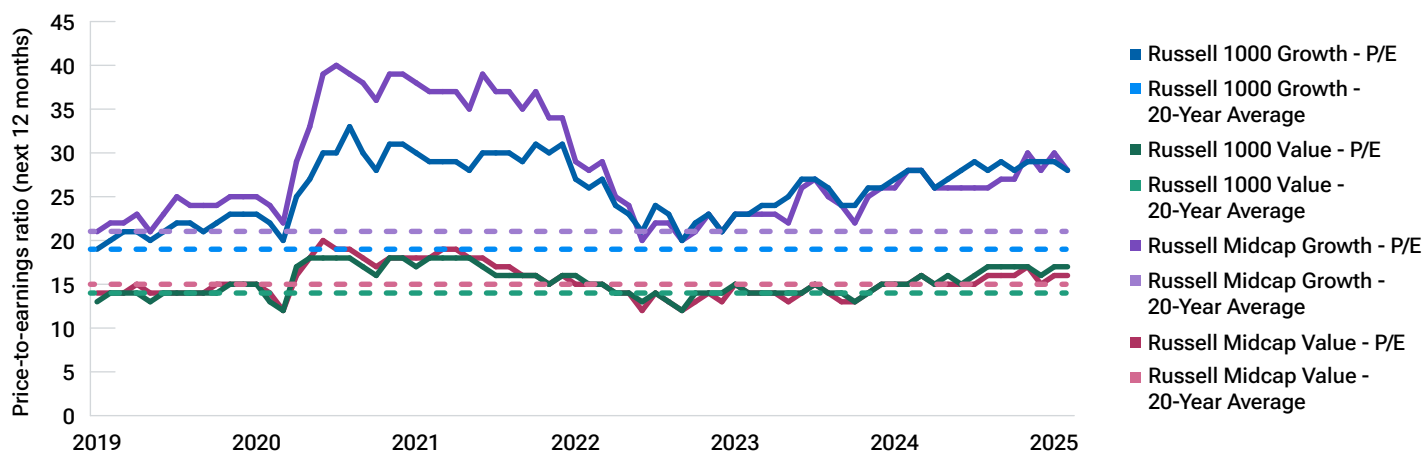
In 2024, we added two key features to this dynamic: (1) the large relative outperformance of U.S. large-caps and (2) narrow market leadership from a small number of U.S. large-cap companies, particularly those that benefited from innovation and substantial investments in artificial intelligence.

Combined, these forces influenced the composition of model portfolios. In our conversations with clients, the Portfolio

“The allure of U.S. exceptionalism can be hard to resist.”

Growth stock valuations look extended versus value stocks

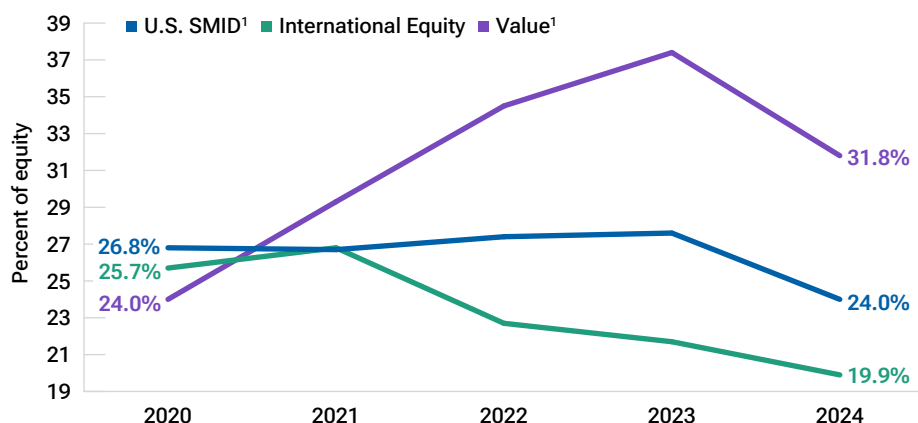
(Fig. 2) Forward P/E valuations: U.S. growth versus U.S. value



Source: Russell® via FactSet data and analytics. See Additional Disclosures.

Allocations to international, U.S. SMIDs, and U.S. value stocks have fallen to lowest levels in five years

(Fig. 3) Percent allocation to select equities in moderate-risk advisor models



¹ U.S. SMID and value are shown as a percentage of U.S. equity allocations.

Source: T. Rowe Price Client Investment Platform database of U.S. advisor models.

Construction Solutions team has started to see cracks both in overall diversification and an increased U.S. portfolio bias.

Figure 3 demonstrates the extent advisors have drifted away from diversifiers such as international equities, U.S. value, and U.S. SMIDs in favor of U.S. large-caps. In fact, our proprietary data suggest that 2024 showed the lowest allocations to international stocks and U.S. SMIDs that we've seen in advisor models over the past five years.

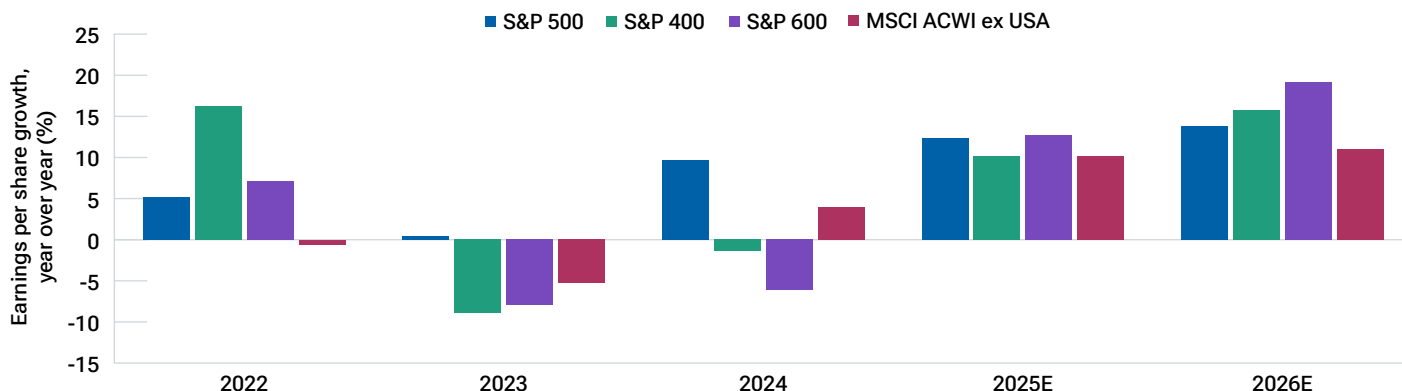
...but now is not the time to give up on diversification.

Now may be the wrong time to give up on diversification. Figure 4 shows the history of earnings per share growth since 2022 and forecasts for 2025 and 2026. If the estimates for 2025 materialize as expected, there will be a convergence of earnings growth across equity market capitalization ranges and regions, including U.S. versus international. Coupled with more attractive valuations, the convergence of earnings growth could be a catalyst for other asset classes to outperform U.S. large-caps.

“ Coupled with more attractive valuations, the convergence of earnings growth could be a catalyst for other asset classes to outperform U.S. large-caps.

Earnings growth is likely to converge in the coming years, highlighting opportunities outside of U.S. large-caps

(Fig. 4) Growth of earnings per share in U.S. large-caps, SMIDs, and international stocks



Sources: Standard & Poor's, MSCI via FactSet data and analytics. See Additional Disclosures.

As previously demonstrated, U.S. large-caps appear to have similar growth prospects as other equity categories but are trading at richer valuations. In addition, the T. Rowe Price Asset Allocation Committee currently has overweight allocations to international, U.S. mid-caps, and value stocks in our firm's suite of multi-asset portfolios.

How to use smart diversification in your portfolios

As our Portfolio Construction Solutions team works with financial professionals, we look for opportunities to apply smart diversification to model portfolios. This approach looks forward to anticipate future expectations rather than focusing on the past. In our conversations, we often ask: How likely is it that an expensive asset class with high expectations will outperform a basket of cheaper asset classes with similar earnings growth? The answer often leads back to a conversation about the potential benefits of diversification.

Here are some ways advisors could reposition portfolios through smart diversification:

- Pick one or two asset classes to work on first. For example, increase diversification with U.S. mid-caps and/or international equity.
- Add strategies that address two diversification needs with one holding, such as mid-cap value or international value.
- Look for flexible mandates such as all-cap strategies or global strategies and let expert managers leverage their expertise and resources to allocate to the best opportunities.
- If you want to maintain U.S. large-cap growth or blend allocations, look for managers who may be taking a different approach to the benchmark. For example, select a growth strategy that employs “growth at a reasonable price” versus momentum growth.



As our Portfolio Construction Solutions team works with financial professionals, we look for opportunities to apply smart diversification to model portfolios.

T. Rowe Price identifies and actively invests in opportunities to help people thrive in an evolving world, bringing our dynamic perspective and meaningful partnership to clients so they can feel more confident.

Additional Disclosures

MSCI and its affiliates and third party sources and providers (collectively, "MSCI") makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI. Historical MSCI data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. None of the MSCI data is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such.

London Stock Exchange Group plc and its group undertakings (collectively, the "LSE Group"). © LSE Group 2025. FTSE Russell is a trading name of certain of the LSE Group companies. Russell® is a trade mark of the relevant LSE Group companies and is used by any other LSE Group company under license. All rights in the FTSE Russell indexes or data vest in the relevant LSE Group company which owns the index or the data. Neither LSE Group nor its licensors accept any liability for any errors or omissions in the indexes or data and no party may rely on any indexes or data contained in this communication. No further distribution of data from the LSE Group is permitted without the relevant LSE Group company's express written consent. The LSE Group does not promote, sponsor or endorse the content of this communication. The LSE Group is not responsible for the formatting or configuration of this material or for any inaccuracy in T. Rowe Price's presentation thereof.

The S&P 500 Index, S&P 400 Index, and S&P 600 Index are products of S&P Dow Jones Indices LLC, a division of S&P Global, or its affiliates ("SPDJ"), and has been licensed for use by T. Rowe Price. Standard & Poor's® and S&P® are registered trademarks of Standard & Poor's Financial Services LLC, a division of S&P Global ("S&P"); Dow Jones® is a registered trademark of Dow Jones Trademark Holdings LLC ("Dow Jones"). T. Rowe Price's products are not sponsored, endorsed, sold or promoted by SPDJI, Dow Jones, S&P, their respective affiliates and none of such parties make any representation regarding the advisability of investing in such product(s) nor do they have any liability for any errors, omissions, or interruptions of the S&P 500 Index.

CFA® and Chartered Financial Analyst® are registered trademarks owned by CFA Institute.

Important Information

Risk Considerations

All investments are subject to market risk, including the possible loss of principal.

Diversification cannot assure a profit or protect against loss in a declining market.

Growth stocks are subject to the volatility inherent in common stock investing, and their share price may fluctuate more than that of a fund investing in income-oriented stocks.

The value approach to investing carries the risk that the market will not recognize a security's intrinsic value for a long time or that a stock judged to be undervalued may actually be appropriately priced.

Mid-caps generally have been more volatile than stocks of large, well-established companies.

Small-cap stocks have generally been more volatile in price than large-cap stocks.

International investments can be riskier than U.S. investments due to the adverse effects of currency exchange rates, differences in market structure and liquidity, as well as specific country, regional, and economic developments. These risks are generally greater for investments in emerging markets.

Past performance is not a guarantee or a reliable indicator of future results. All charts and tables are shown for illustrative purposes only.

The views contained herein are those of authors as of March 2025 and are subject to change without notice; these views may differ from those of other T. Rowe Price associates. This material is provided for general and educational purposes only and not intended to provide legal, tax, or investment advice. This material does not provide recommendations concerning investments, investment strategies, or account types; it is not individualized to the needs of any specific investor and not intended to suggest any particular investment action is appropriate for you. T. Rowe Price group of companies, including T. Rowe Price Associates, Inc., and/or its affiliates, receive revenue from T. Rowe Price investment products and services.

Portfolio construction services discussed are available only to financial professionals and not to the retail public.

T. Rowe Price Investment Services, Inc., Distributor. Art of Clean Up® and Asset Allocation Model Review are offered by T. Rowe Price Investment Services, Inc. Model Construction is offered by T. Rowe Price Associates, Inc. T. Rowe Price Associates, Inc., and T. Rowe Price Investment Services, Inc., are affiliated companies.

© 2025 T. Rowe Price. All Rights Reserved. T. ROWE PRICE, INVEST WITH CONFIDENCE, the Bighorn Sheep design, and related indicators

(troweprice.com/en/intellectual-property) are trademarks of T. Rowe Price Group, Inc. All other trademarks are the property of their respective owners.