TD Wealth

Windshields vs. Rear-view Mirrors
The case for diversification

Market Insights

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Wealth Investment Office

Windshields vs. Rear-view Mirrors

The case for diversification has never been stronger. While the U.S. has been and remains a force of innovation and economic stability, investors must be cognizant of the increased concentration risk

By Mansi Desai, Portfolio Manager, Equities | TD Wealth

Warren Buffett once said, “Investing is simple but not easy.” How do you allocate capital in an environment where recency bias — the bias of forecasting future returns based on past performance — has consistently rewarded investors for more than a decade? At the Wealth Investment Office, our answer across all market environments remains the same: always ensure proper diversification. One step in that strategy is to allocate capital where prospective risk-adjusted returns are higher. Just as you wouldn’t drive a car by looking only in the rear-view mirror, capital-allocation decisions in the investment world should not be influenced by historical returns.

Today, this holds true for many equity portfolios where U.S. equities account for more than 80% of equity exposure, based on strong historical earnings growth, meaningful multiple expansion after 2015, and enhanced incremental returns on invested capital. These factors have led to the highest recorded share of U.S. equities in the global equity index (MSCI ACWI) at 65%. As of December 2024, the market capitalization of all listed companies in the U.S. reached its highest share of GDP, at 213%.

This is magnified for some as many individual investors now have virtually zero exposure to international equities. Significant exposure to U.S. equities carries the added risk of heavy concentration in the AI theme, which has been a strong driver of U.S. equity performance. This has created an asymmetrical risk profile for many portfolios, which has worked well recently but will present meaningful risk if the AI theme falls out of favour. While we are not calling for such a downturn, we are mindful of the asymmetric risk present in many portfolios and the need for investors to review their equity allocations.

After underperforming for several years, international equities have delivered generally positive returns in 2025, and we believe there are still some interesting opportunities available. While we continue to recommend a modest underweight allocation to international and emerging-market equities, that does not mean a 0% allocation to these regions. In our missive below, we address the key questions posed by investors on the rationale to diversify outside of US equities.

Historically, economic as well as earnings growth in the US has been significantly stronger than international equities. Are there factors that could narrow that gap?

We don’t want to overstate the case. The investment landscape in U.S. equities remains superior to international equities, given stronger economic growth, a significantly evolved financial system (especially after the global financial crisis), and the earnings growth that has thrived due to massive innovation. It will be difficult for any other country to replicate the growth opportunities that U.S. equities offer. However, there are factors that will also drive higher growth in other regions over the next few years, and this will lead to some attractive opportunities in international markets.

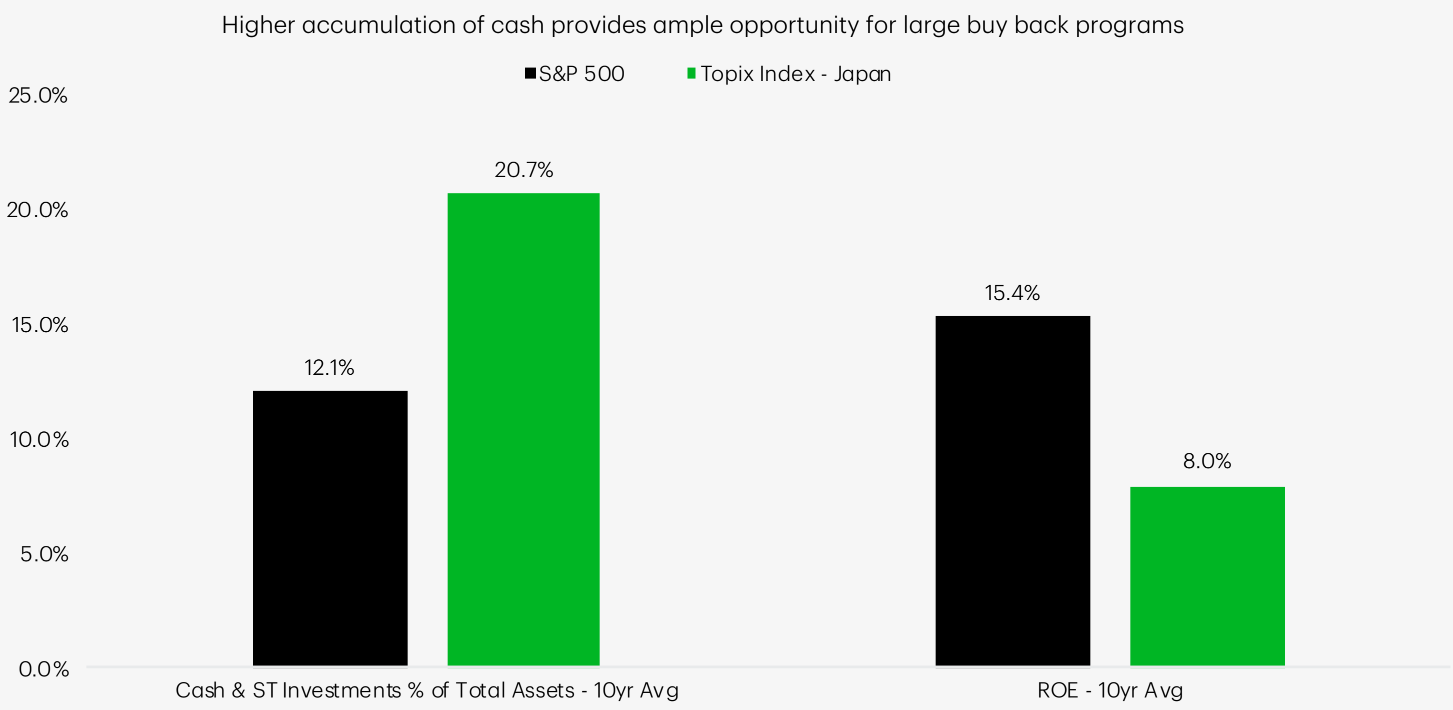
Europe's commitment to spend about 5% of GDP on defence and related infrastructure by the end of this decade, for instance, is expected to boost growth in the manufacturing sector, which has recorded sluggish growth of 1.5% since 2019. There are many hurdles that Europe will have to resolve before it can meet this commitment, such as consolidating the fragmented defence industry, securing funding without further leveraging government debt, and establishing manufacturing expertise in critical systems like missile defence, aircraft engines and drones, for which it currently relies on U.S. imports. However, Russia's unwavering stance on the Ukraine war leaves Europe with little choice but to deliver on its defence spending commitment, enabling incremental GDP growth of about 1% to 2% in the coming years. Importantly, advanced technology developed for the defence industry eventually gets utilized by other sectors, which would improve productivity and could potentially create new revenue streams for European companies.

The Transforming Landscape in Japan, EM

After being dormant for almost four decades, Japan is finally coming back to life, with inflation that has been sustained for 40 months — its longest stretch in 30 years. The transition to an inflationary environment will drive the need to seek higher nominal returns, encouraging households to invest in equities. In a deflationary environment, the value of cash rises in real terms, which has resulted in households holding 51% of total assets in cash, compared with 12% in the U.S. and 34% in Europe.

Similarly, corporate reforms requiring companies to raise returns to equity shareholders have resulted in ¥59 trillion (approximately $400 billion) of listed equity buybacks between 2019 and March 2025, equivalent to 10% of Japan's GDP in 2024. With a corporate share of cash to total assets at 20.7%, there's still ample room for Japanese issuers to raise returns to equity shareholders through large buyback programs (Figure 1).

Figure 1: Corporate reforms expected lift ROE in Japan



Source: FactSet, Wealth Investment Office as of September 19, 2025

Moreover, as countries around the world enhance their onshore manufacturing capabilities, leading industrial automation players such as Fanuc, Keyence, Omron Corp. and Mitsubishi Electric — all based in Japan — could benefit.

As for emerging-market equities, TD Economics has forecast the highest GDP growth for 2026 and 2027 in Asia, but multiple factors will drive earnings growth both there and beyond. First off, despite the rising deglobalization theme, Taiwan, South Korea and China have become integral to the AI investment theme (discussed in detail below).

China is also rising as a strong competitor to the U.S. — not just in AI but across the spectrum of advanced technology, especially in electric vehicle (EV) technology. After years of R&D investment in EV and battery technology, nearly two-thirds of the world's EVs and three-quarters of EV batteries are now produced in China. Today, access to efficient batteries produced in China has become critical for the next phase of growth in EVs. Battery companies in China are leading investment in solid-state batteries — a promising technology that could provide a driving range of 1,000 miles versus the current range of 300 to 450 miles, reducing range anxiety for drivers.

And finally, investors have increasingly recognized the demographic advantage that emerging economies offer. This edge helps mitigate the growing threat of deglobalization and import tariffs, given the higher share of the domestic market to total revenues for most emerging countries. Over the past decade, domestic markets in these countries have been a strong source of earnings growth for many EM equities and have delivered similar rates of return on capital to those of the S&P 500 Equal Weighted Index (Figure 2).

Given that South Korea and Taiwan are export-oriented economies, the domestic market's share of total revenue is lower. However, these countries remain integral to the AI supply chain, which will be difficult to disrupt given the decades of expertise and scale advantage in chip production. Earnings growth in China has suffered in recent years due to intense pricing competition, which has led to margin contraction for Chinese equities.

Figure 2: Domestic market serves as a strong source of earnings growth for many EM economies

Countries	% of Revenues sourced from the US	% of Revenues sourced from domestic market	Annlzd 5yr Earnings Growth	Annlzd 10yr Earnings Growth	ROE	Relative Valuation to Historical Mean (since 2010)
S&P 500		58.8%	7.6%	7.0%	15.4%	37.8%
S&P 500 Equal Weighted		69.4%	7.5%	7.9%	10.8%	9.7%
China	3.0%	80.0%	-0.6%	-0.2%	10.1%	21.9%
Taiwan	35.8%	27.4%	11.8%	6.8%	11.8%	27.2%
South Korea	14.2%	46.6%	9.3%	5.4%	7.1%	10.5%
India	8.0%	80.0%	14.9%	9.7%	13.8%	19.0%
Brazil	4.8%	75.0%	16.4%	16.2%	12.0%	-28.6%
Mexico	12.0%	60.0%	5.3%	7.2%	13.4%	-16.9%

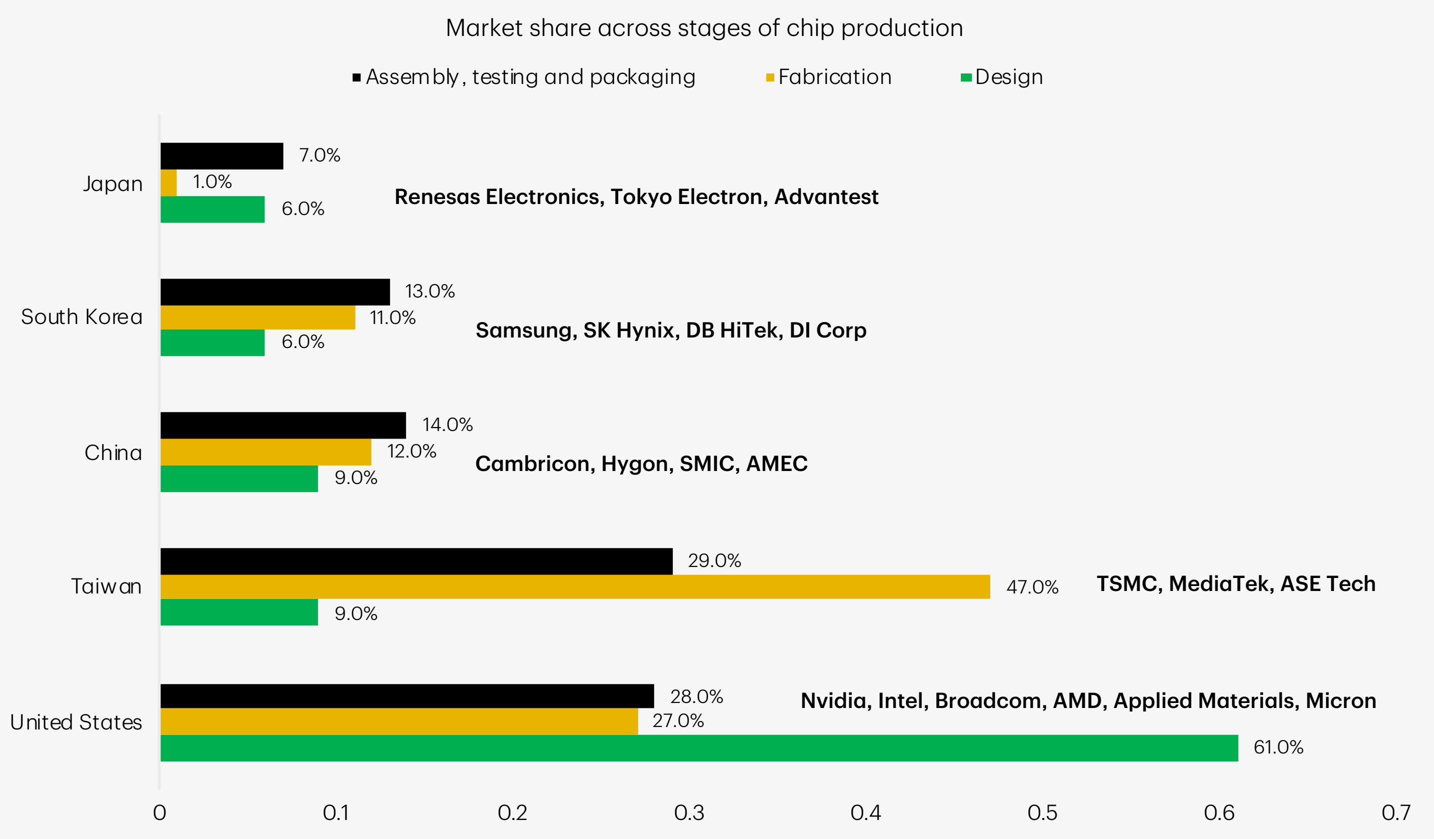
Source: FactSet, Wealth Investment Office as of March 2025
*Valuation premium is as of September 12, 2025

U.S. is leading in AI investment and technology. It has been the center of innovation for many years. Is there a need to consider international equities if Mag 7 and the largest chip designing companies are in the US?

There's no doubt that the U.S. is leading today in AI investments and technology. However, we also recognize that markets are currently focusing on the hyperscalers and semiconductor companies in the U.S. that have been at the forefront of AI investments. The secondary constituents, which are an integral part of the capital expenditure supply chain, are being overlooked to some degree.

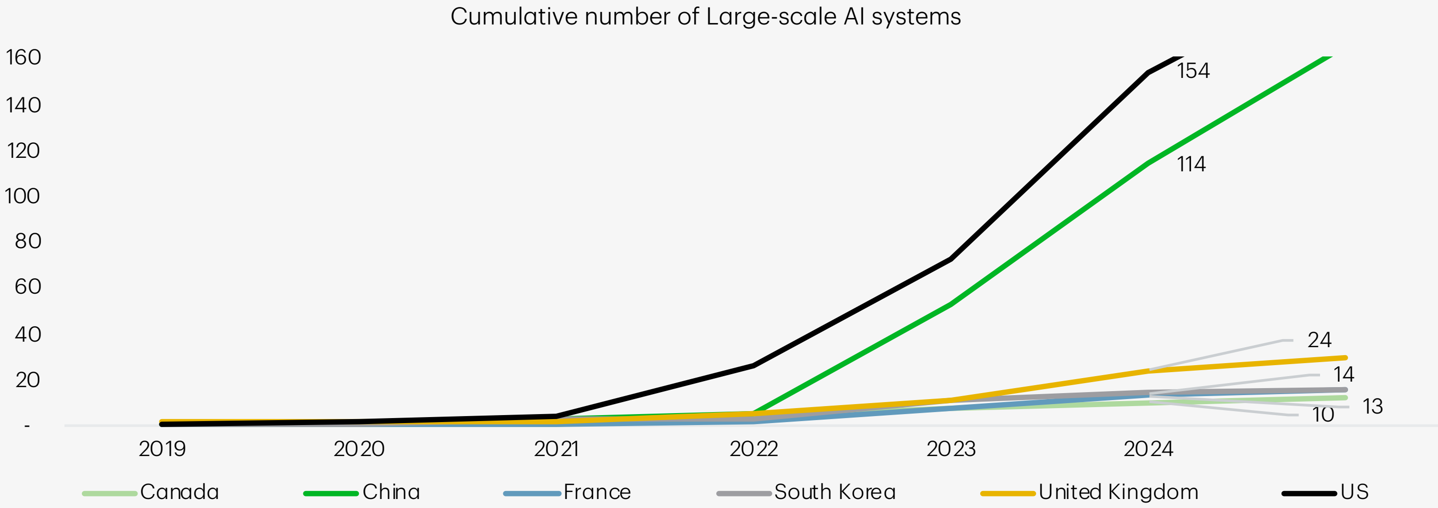
When you take into account the chip production process (Figure 3), it becomes clear that companies based outside of the U.S. also have a contributing role — if not an equal one — in the AI investment theme. In fact, other countries are also gearing toward AI investments and have successfully generated large-scale AI models, especially China (Figure 4). Government intervention in China's tech sector in 2021 reduced the pace of AI investments. However, we expect a similar pace to follow in the future. In March 2025, China's President Xi Jinping called a closed-door summit with tech leaders and vocally expressed his support for China's supremacy in advanced technology areas. There's some trepidation that AI technology might take longer to unfold. The surge in the AI revolution, after all, has led to stellar performance in U.S. equities, which could turn into a bane if AI takes longer to deliver, or worse, is not able to deliver as expected by investors. So far, hyperscalers have invested over $400 billion (around 1.4% of U.S. GDP in 2024) in AI capex, but there is little clarity on the size as well as the timeline of returns on these investments.

Figure 3: AI not just a U.S. opportunity



Source: ourworldindata, FactSet, Wealth Investment Office as of September 19, 2025

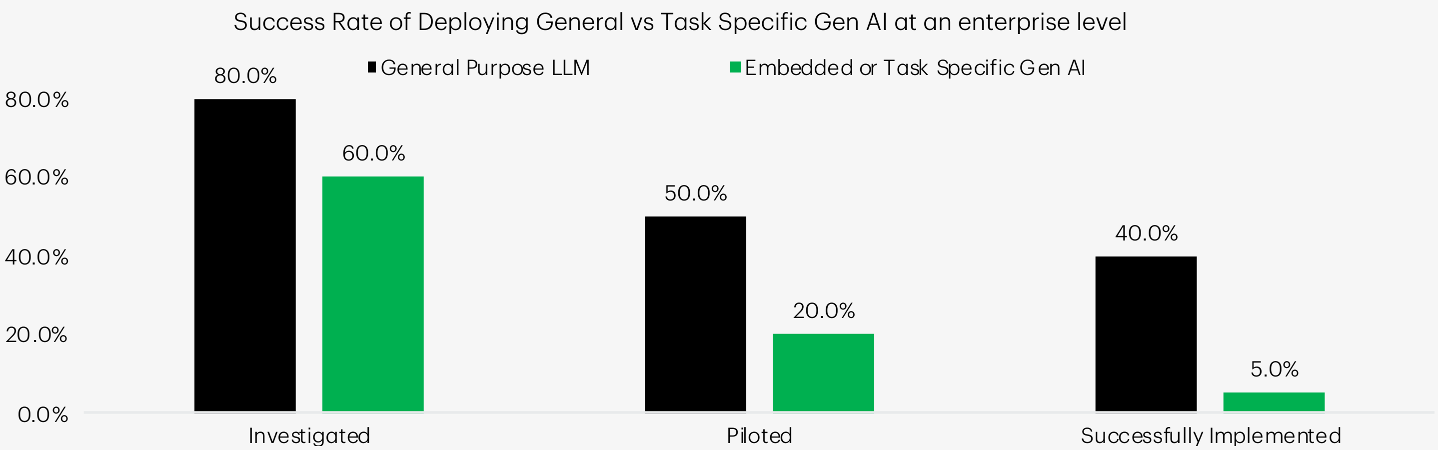
Figure 4: China emerges as a strong AI contender

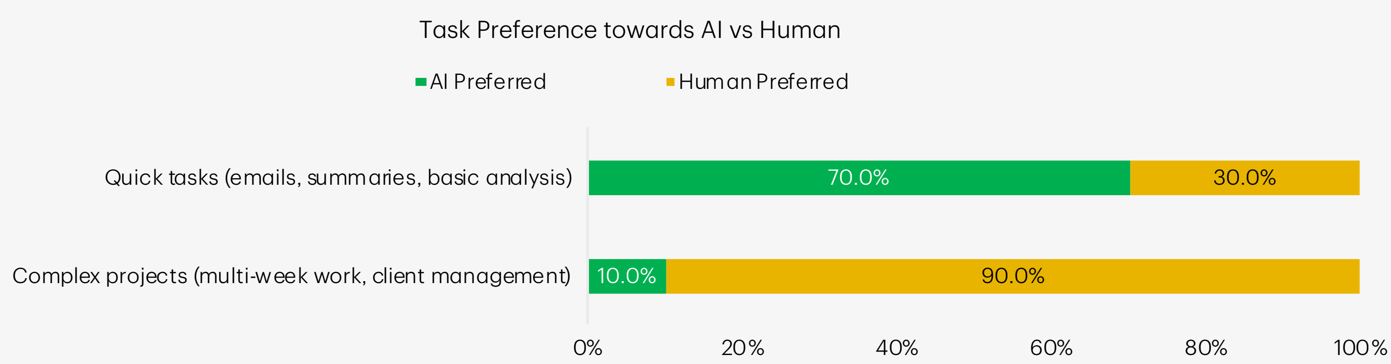


Source: ourworldindata, FactSet, Wealth Investment Office as of September 19, 2025

According to a recent study published by MIT, the success rate of implementing general-purpose LLMs that can execute mundane tasks at the enterprise level was much higher than the success rate of implementing complex-task AI (Figure 5).

Figure 5: Limitations recorded by MIT Study for Gen AI





Source: MIT Study-Gen AI Divide, Wealth Investment Office as of September 19, 2025

The findings revealed that the primary shortcoming in implementing complex projects at the enterprise level has been the inability of the models to learn from feedback and adapt to context over time. While we don't question the ability of AI to boost productivity across the business spectrum, we recognize that every new technology has an evolution phase and a learning curve. For example, the evolution of the internet — which eventually led to a 1.5% annual rise in productivity — still took about 40 years to meaningfully drive the earnings growth of companies.

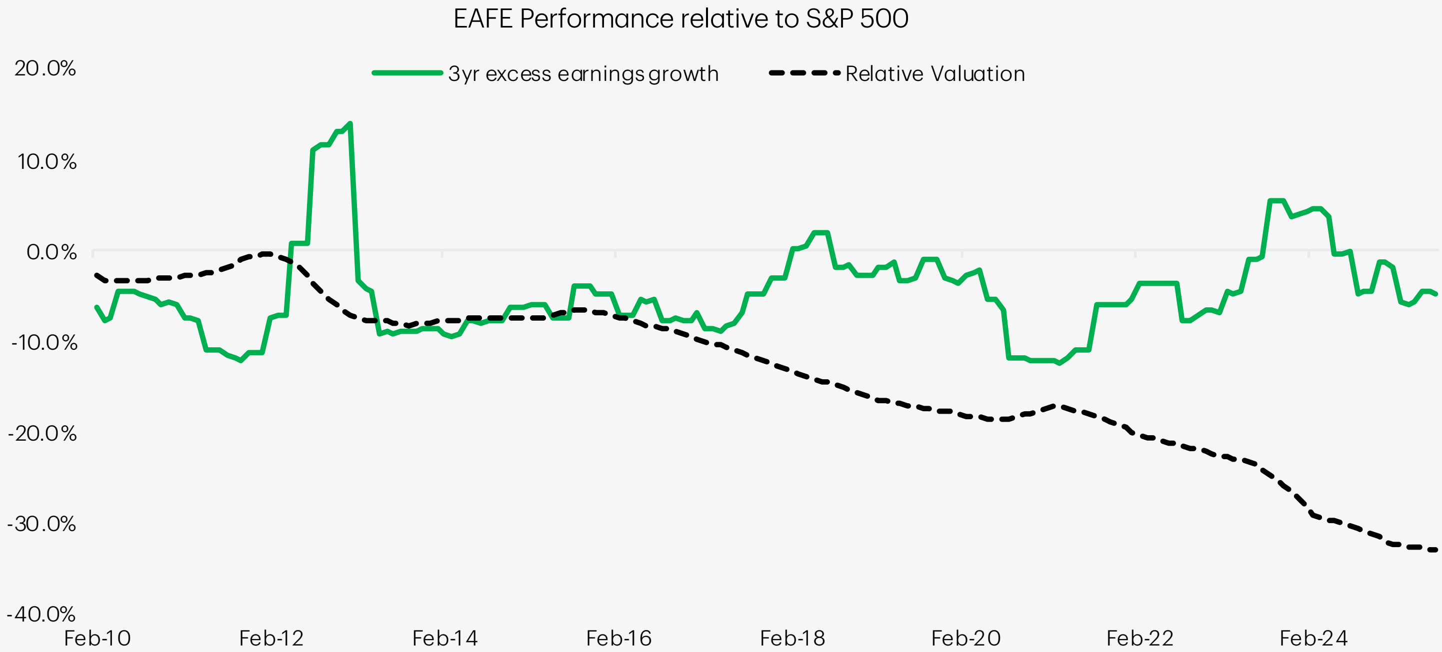
Concentration Risks

Over the past decade, U.S. equities have delivered stellar performance backed by 8.4% annualized earnings growth, combined with a significant expansion of 400 bps in return on equity during this period. Much of this can be attributed to earnings growth in the technology sector, which consists of high-margin, less capital-intensive businesses. Structural growth in technological evolution — from software to cloud infrastructure to social media platforms — has led to higher cash flow generation.

Such a strong profitability profile led investors to flock to U.S. stocks over the past decade, leading to higher valuation dispersion between U.S. and international equities and significant concentration in the S&P 500, wherein the technology sector and the Magnificent 7 together account for about 34% of the index.

Historically, the valuation premium for U.S. equities was justified by the earnings-growth gap and superior profitability profile. However, after Covid and especially after ChatGPT's launch in late 2022, dispersion in valuation premiums expanded even though the gap in earnings growth over a three-year period narrowed (Figure 6). This signifies that investors have overlooked improvements in earnings growth outside of the U.S., driven by the exuberance surrounding strong growth expected from AI investments. While we don't deny the strong growth prospects for AI stocks, we feel at some point these overlooked companies that have delivered strong earnings growth will also catch up.

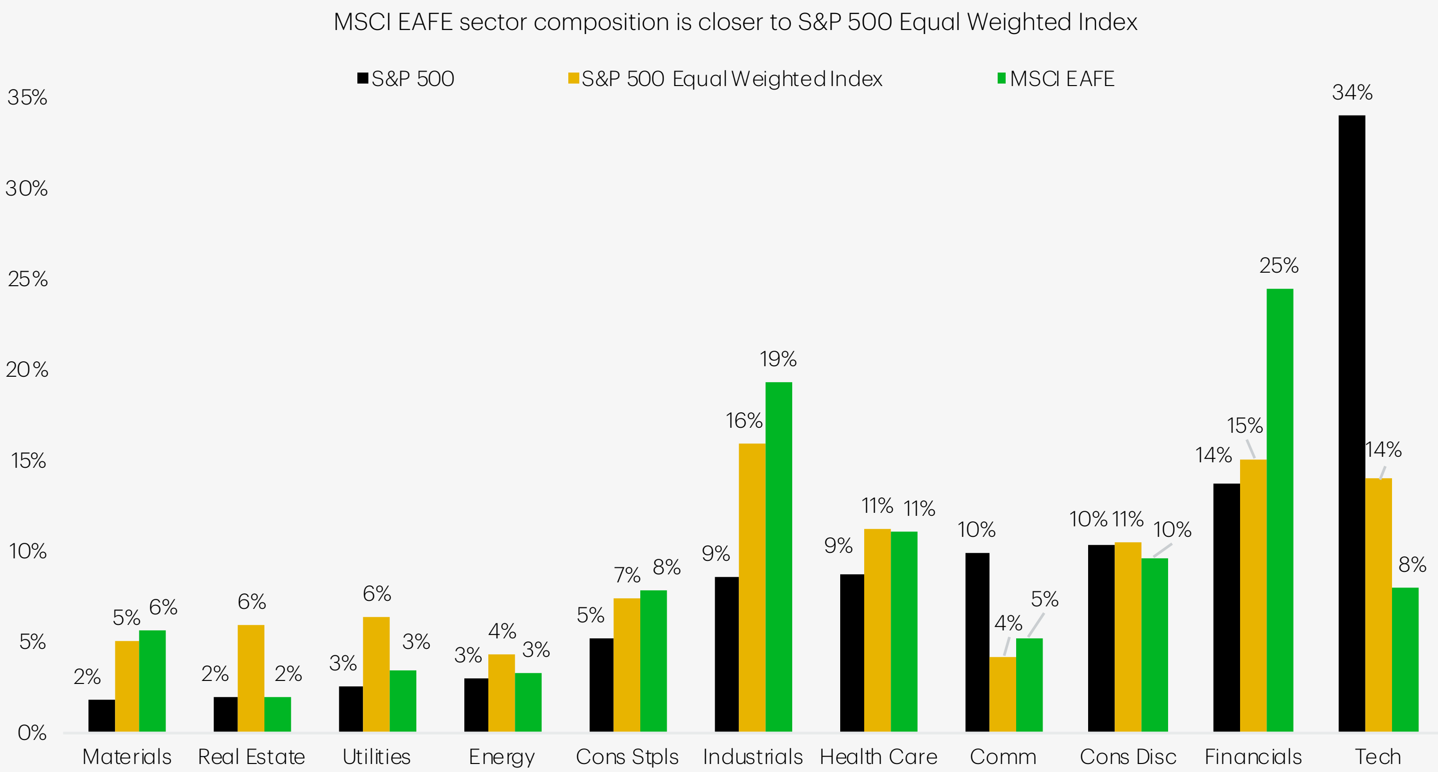
Figure 6: Valuation gap rises despite narrowing EPS gap



Source: FactSet, Wealth Investment Office as of September 19, 2025

Interestingly, the underlying index composition for the MSCI EAFE is more comparable to the S&P 500 Equal Weighted Index than to the S&P 500, which over the years has become skewed toward tech, media and communications. Outside of the S&P 500, the profitability profile for the MSCI EAFE and the S&P 500 Equal Weighted Index is similar, justifying diversification into a larger opportunity set outside of the U.S. (Figure 7).

Figure 7: Allocation profile for international stocks similar to S&P 500 Equal Weighted Index



	5yr Earnings Growth	5yr Avg ROE	5yr Avg Operating Margin
S&P 500	7.6%	16.6%	13.4%
S&P 500 Equal Weighted	7.5%	10.9%	9.0%
MSCI EAFE	5.4%	10.0%	10.9%
MSCI Europe	5.6%	11.0%	11.5%
TOPIX Index - Japan	9.8%	7.7%	7.2%

Source: FactSet, Wealth Investment Office as of September 19, 2025

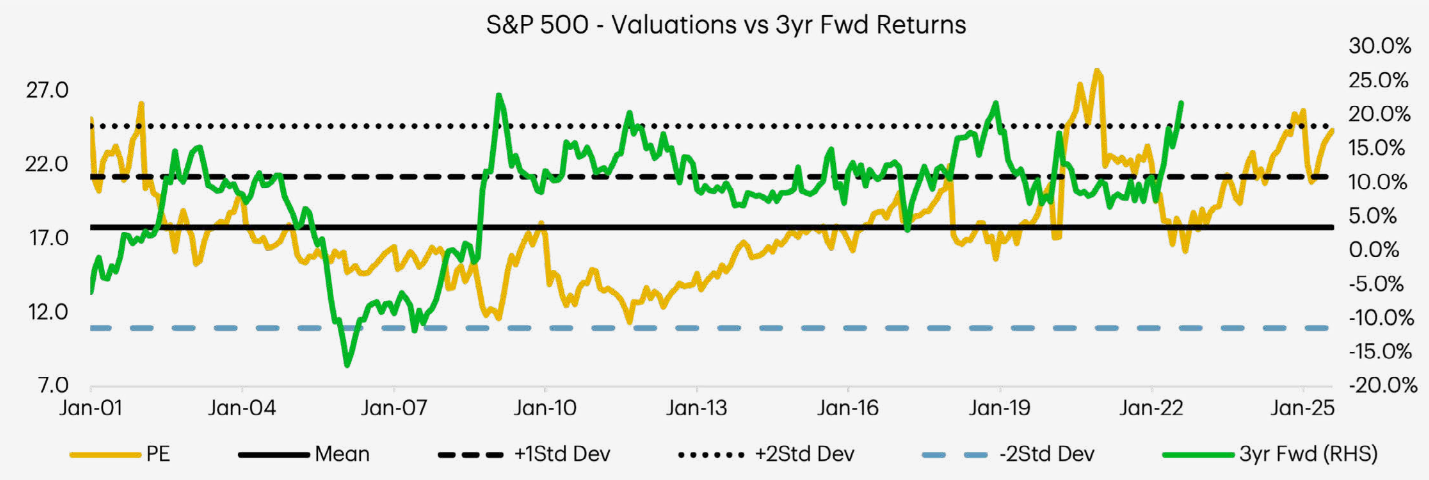
The valuation gap between US and International equities has persisted over the past 15 years. Can valuation gap be a serious risk for future returns if underlying strong earnings growth in the US persists?

Over the long term, equity returns reflect underlying earnings growth combined with dividend yield. However, this relationship can falter when valuation levels are elevated and equities are pricing in peak earnings growth into perpetuity. While it's difficult to predict the peak in earnings growth, history shows that returns are lower following periods where valuations are stretched. What is less clear is the timeline.

In Figure 8, we plotted monthly PEs against three-year forward returns, demonstrating the range of future returns across valuation bands. It is shown that when valuations hover between +1 and +2 standard deviations, three-year future returns have declined to a range of +6% to -17.0%. Certainly, there are periods when valuations are above +1 standard deviation, while three-year future returns have been above 10%. Such a trend, however, has not lasted long.

Another sign of exuberance can be seen in earnings growth. Many times, valuations become normalized when underlying earnings growth is very strong. But if earnings growth is not sustainable, it can bring disappointment to investors who have extrapolated peak earnings growth into the future, leading to price pullbacks.

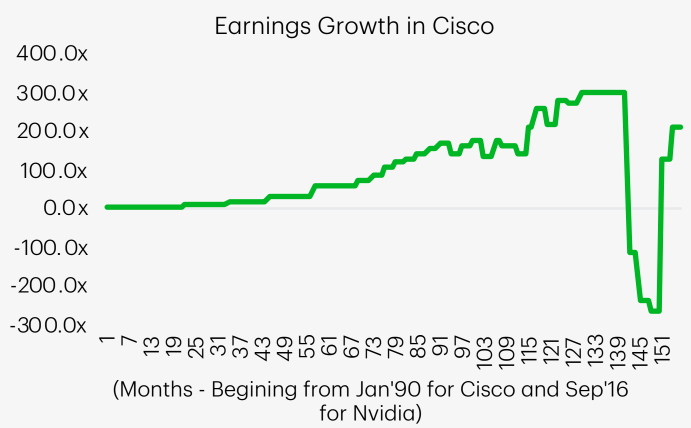
Figure 8: U.S. stocks have been pricey for a while

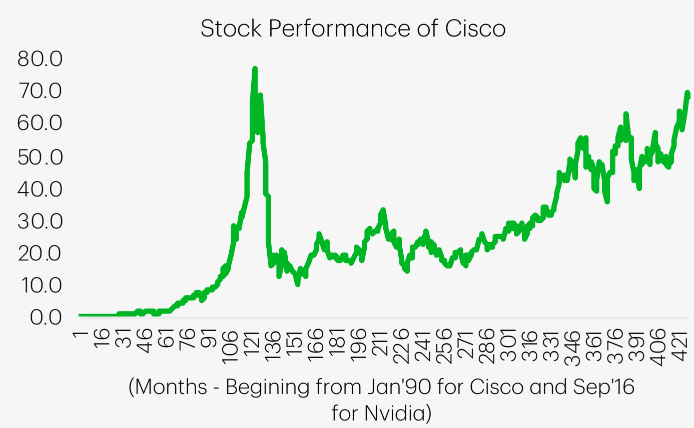


Source: FactSet, Wealth Investment Office as of August 30, 2025

For example, Cisco's EPS grew 300 times between January 1990 and September 2001. Investors, however, extrapolated the peak earnings growth of 80% recorded between 1990 and 1996 to perpetuity, which led to PE expansion beyond 75 times against a historical average of 30 times. As Cisco's earnings growth normalized, investors grew disappointed, leading to an 84% collapse in the stock price between March 2000 and September 2001 (Figure 9).

Figure 9: Cisco offers a case study in exuberance



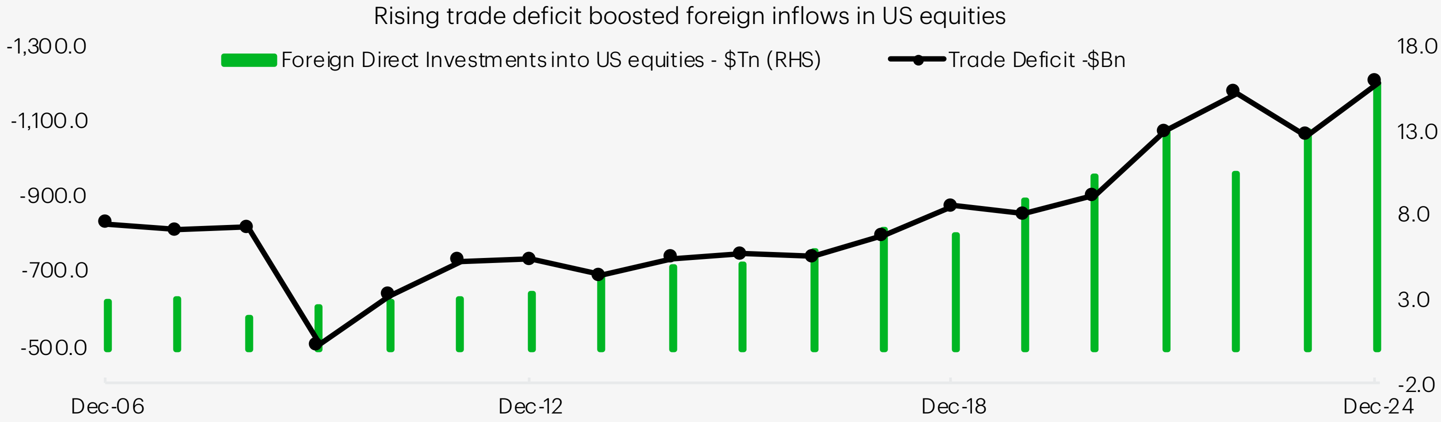


Source: FactSet, Wealth Investment Office as of August 30, 2025

Even though Cisco's EPS only took two years to surpass its previous peak, the stock price has still not surpassed its historical peak recorded in March 2000. Cisco's illustration is a strong reminder to investors to evaluate the valuation premium they pay for growth versus the timeline for which such growth is sustainable.

Besides valuation risks, there are other macro risks that have amplified post the change in the U.S. administration. The new U.S. administration's tariff policies are reshaping global trade dynamics, potentially reducing the trade deficit and, consequently, foreign inflows into U.S. equities (Figure 10).

Figure 10: Rising trade deficit boosted inflows into U.S. equities

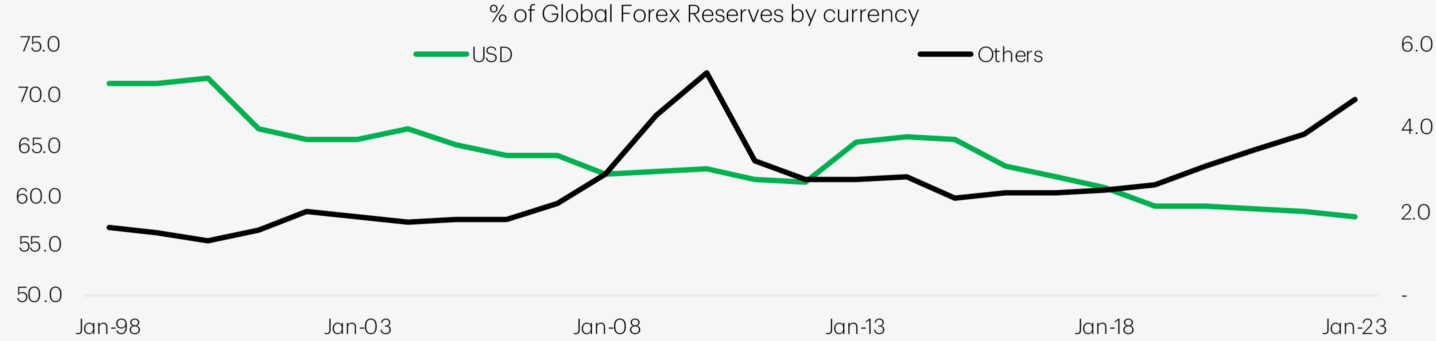


Source: World Bank, Wealth Investment Office as of June 8, 2025

Meanwhile, the U.S. fiscal position is weakening. Although the One Big Beautiful Bill Act (OBBBA) may provide short-term growth through tax cuts and stimulus, it is expected to increase debt-to-GDP ratio by 7.0% and primary deficit by 1.0% over the next decade, putting upward pressure on long-term Treasury yields. These developments, coupled with trade and fiscal imbalances, point to a weaker U.S. dollar over time. The global reserve share of the USD has already fallen, reflecting diversification toward other currencies and assets (Figure 11). Finally, escalating political risks — including strained international relations and threats to institutional independence — further undermine confidence in U.S. exceptionalism, reinforcing the case for global diversification.

In today's environment, capital allocation and risk diversification have become crucial. While you remain invested in growth themes, incremental capital should be diversified across other asset classes that are poised to provide higher risk-adjusted returns in the future.

Figure 11: Rising share of other currencies in global forex reserves



Source: IMR COFER, Wealth Investment Office as of September 19, 2025

Conclusion: A stronger case for diversification

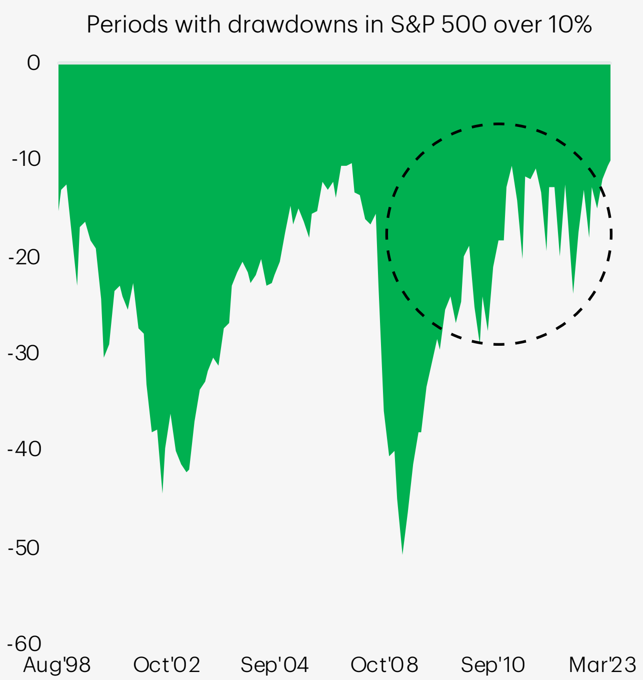
Today the case for diversification outside of the U.S. is stronger not because we expect international equities to replace the higher economic growth recorded in the U.S., but because investors need to be aware of the increased risks of concentration and crowded momentum in U.S. equities. The transformation in the U.S. administration and the consequences of the adapted policies could pose risks to the U.S. economy and the U.S. political system.

Moreover, the economic gap between the U.S. and other countries is also expected to narrow. If we all agree that the shift in the global economic order has accelerated, then there is no guarantee that future returns in equity markets will be similar to the historical returns recorded over the past decade. Indeed, beyond international equities, investors should also be looking into alternative asset classes as a way of diversifying their portfolio.

Prior to 2010, there were multiple periods when drawdowns in equities exceeded 10%. After the global financial crisis, both the frequency and duration of drawdown events decreased considerably, due to loose monetary conditions and secular growth in specific sectors (Figure 12). This supports the case to diversify into low-correlated assets, such as equity alternatives in the form of liquid alternative ETFs, hedge strategies, real assets and private assets.

At TD Wealth, we don't try to predict the future; instead, we work towards building an all-weather portfolio. Investors often obsess over historical returns, but in the real world, we all know the fate of a person who drives by looking only in the rear-view mirror.

Figure 12: Limited drawdowns raise concentration in equities



Source: Factset; Wealth Investment Office as of Sep 19, 2025

Where we stand on allocation right now

Below you can find links to insightful reports published by Wealth Investment Office at TD Wealth that emphasize the benefits of diversification and outlines our asset allocation process.

[Capital Market Assumption Report]

[Strategic Asset Mixes Report]

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