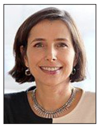
Take an Active Approach to Valuation Risk and Diversification

The economic backdrop is still conducive to returns, but diversification will be essential for building resilient portfolios.

Insight from sub-adviser Schroders Investment Management



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As we head into 2026, there's a lot of concern about equity-market valuations. Comparisons are being drawn with the dot-com bubble of 1999-2000 due to significant investments being made by the hyperscalers into data centers and cloud infrastructure. At the same time, many AI start-ups are losing money, with their valuations being boosted by vendor financing. Against this backdrop, we've heard talk about canaries in coal mines, cockroaches (i.e., where one emerges there are usually many), and staying at the party for one last dance.

But let's leave analogies to one side and focus on our options.

Key Points

- Equity valuations are high, so consider trimming risk—but staying on the sidelines too long could mean missing out on long-term growth.
- Active, stock-specific investing may remain essential; we see opportunities, especially as mega-cap techs evolve and market risks stay relatively contained.
- Diversification may matter more than ever. Think beyond AI and the US, with value and emerging-market debt offering fresh potential.

The Risks of Too Much Risk Reduction

First, equity valuations are expensive. While they've not at extremes yet and have been more expensive in the past, you could argue for taking some risk off the table. For example, if you run a mature defined-benefit pension plan, you might be able to accept a lower rate of return at this point and bank some profit.

Most investors aren't in this camp, however. There are costs to sitting on your hands: Inflation needs to be outrun to preserve the value of savings and, with limits on how much can be saved, money has to be worked hard to deliver the funds required for retirement and other goals. You need a plan for the possibility that you could be waiting a long time for a correction and the golden buying opportunity.

The passive option is to stay invested in an equity index. Over the long term (20 years), history shows that equities deliver a decent return[1], particularly if fees are kept as low as possible to aid the compounding of those returns. The challenge with this approach is that, due to the concentration of equity indices in a small group of technology companies, you're particularly exposed to the equity valuations that everyone is so worried about. There's also significant idiosyncratic stock risk, if anything should go wrong with one of these large holdings.

I worry that not all investors realize how concentrated their exposure is. It's not always clear, in the case of passive investment, who oversees that risk for them.

Active Investing and Calculated Risks

Alternatively, you can try to risk-manage the situation. As active investors, we take calculated risks based on a broad range of factors, knowing that over time our clients need a return. Looking at market valuations, we think that equity markets are still supported by the fact that bond yields are well-behaved, inflation is quiescent for now, and central banks are likely to ease a bit more.

Over the medium term, I'm concerned about mounting government debt levels and the potential for inflation to accelerate, leading to higher discount rates, but over the next six months this risk is low. We also see low risk of a US recession; although the labor market is softening, unemployment is still low and private-sector balance sheets are in good shape. So, at a market level, we still see positive returns from equities.

[1] For the past 20 years (through 12/9/25), the average annualized return on global equities, as measured by the MSCI ACWI Index, was +8.17%. MSCI ACWI is a free float-adjusted market capitalization index that measures equity market performance in the global developed and emerging markets, consisting of developed and emerging market country indices. MSCI index performance is shown net of dividend withholding tax. Sources: Schroders, Bloomberg, 12/25.

There's the question of stock-specific risk, which I raised above, but we still see the potential for the hyperscalers to deliver revenues. We're monitoring the return on investment of these mega-cap companies as they have evolved from free-cash-flow monsters to big spenders, and we're also watching the performance of large-language-model and cloud-computing companies as a reflection of the adoption of the new technologies.

The bottom line is that we still see opportunity at the individual-stock level. Critically, we take this risk deliberately, backed by detailed fundamental analysis, rather than reliance on the weight of a stock in the index.

Diversification? Yes, Please!

Finally, we're finding opportunities for diversification. It hasn't been all about AI. 2025 has shown the benefit of geographical diversification, and the value style has performed outside the US. Emerging-market debt also my offer better dynamics and higher real yields than developed-market debt.

As active investors, we don't have the luxury of talking in vague terms about risks on the horizon. We have to take a view. For 2026, we see a low risk of recession, contained bond yields, and momentum in company earnings—which leads us to stay positive. Our processes allow us to quickly recognize if our views change or if we get it wrong, so that we can adapt and adjust our strategy.

The waters are getting choppier, but we still see ways of navigating them to get to our destination. It's too soon to seek shelter.

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Talk to your financial professional about incorporating active and diversified approaches into your investment plan.