

FEAR, FOMO OR FUNDAMENTALS?

A FORWARD-LOOKING FRAMEWORK FOR EQUITY ALLOCATIONS

We believe asset allocation decisions should be based on long-term views and portfolio risk parameters, not on recent market performance.

KEY TAKEAWAYS

- Adjusting asset allocations based on recent performance is like driving using the rearview mirror. We think there is a better approach: Focusing on forward-looking, fundamental drivers of returns.
- Despite U.S. equity outperformance over the past decade, we believe high valuations and earnings pressure indicate this scenario is unlikely to repeat.
- In our view, a fundamentals-based, forward-looking framework — not fear, regret or AI-driven fear of missing out (FOMO) — should guide allocation decisions.



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Recent market performance has created a more challenging backdrop for evaluating equity allocations. Many investors, motivated by the fear of missing out, see the remarkable run of U.S. equities since 2009 and want to boost their exposure to U.S. stocks.

Others think the run-up in U.S. equities over the past decade-plus has created a risky situation, that the tide will have to turn and that they want to reduce their exposure to avoid a big hit.

Despite applying rigorous asset allocation frameworks, recency bias can shift the emphasis toward the last 15 years of performance instead of the underlying fundamentals today. But making investment allocation decisions based on recent history may lead asset owners to significantly increase or decrease risk based on emotions rather than objective logic.

Given the stock market's performance since ChatGPT was unveiled in November 2022, constant coverage of the transformative power of artificial intelligence (AI) has led many to regret not having had greater exposure to U.S. equities. With soaring returns for the "Magnificent 7" stocks and other AI leaders, many are concerned about missing future returns and are considering increasing their U.S. equity allocations. After all, why not place more confidence in an asset class that has delivered strong results over an extended period and may offer more of the same? Such investment decisions may be based on fear or greed, not on rational analyses of stock market fundamentals.

In this paper, we examine what drove U.S. equity returns during the prolonged bull market of the past 15 years, starting with the basics: earnings and valuation multiples. We then investigate what it would take for U.S. equities to continue delivering such strong returns, and what other paths they might take. Lastly, we contrast U.S. equities with those of other developed economies. We believe this approach provides a framework for how asset owners should assess their equity allocations today.

A VALUATION-BASED FRAMEWORK FOR ASSESSING EQUITY RETURNS: A PRIMER

To state the obvious, we include stocks in a diversified investment portfolio because we believe they will generate attractive risk-adjusted returns over time, through a combination of dividends and price appreciation. Importantly, future stock returns depend largely on current prices. We look at the potential for stocks to move higher, not based on how much they have moved in the past year or two (or 10), but on the outlook for future earnings and how much investors are likely to pay for those earnings. Comparing forecasted earnings to current price levels (the P/E multiple) provides a structured way to assess how much room stocks might have to move higher.

Expressing this as a simple equation, equity returns can be described as:

Total Return = Dividends + EPS Growth + Change in P/E + Compound Term

Where:

EPS Growth = Revenue/Share Growth + Profit Margin Growth

These formulas help us forecast total returns and analyze past performance by breaking results into their individual components. The following are several observations about the components of equity returns:

- Dividend growth has been fairly stable over time, in line with historical averages.
- Earnings per share (EPS) growth is a function of growth in revenue per share and changes in profit margins.
- Revenues can, in theory, increase infinitely, but both historically and theoretically, that growth should track growth in nominal GDP, which is the sum of inflation and changes in real GDP.
- While inflation has been unusually volatile in recent years and could experience similar volatility in the future, the U.S. Federal Reserve has a mandate to maintain price stability.
- Real GDP growth has been consistent in recent decades, remaining within a tight band of 2% to 2.5% annual growth outside recessions.
- Profit margins and P/E ratios are often connected. They are also the least predictable and typically most impactful of the variables in our equation, as we discuss in the next section.

CORPORATE PROFITS AND VALUATIONS ARE LINKED, BUT NOT RIGIDLY

We can think of the connection between profit margins (earnings) and stock valuations as two interlocking rubber bands. One or the other or both may have some slack at times, and at other times, one or both can be stretched.

The two often reinforce each other — for example, rising profit margins may justify higher valuations. They can also act independently for some period — we may see valuations push higher without evidence that earnings are rising, and earnings may increase or decrease with little impact on valuations.

But neither of these two inputs that drive stock prices can stretch indefinitely. Profit margins cannot expand infinitely. An age-old observation reminds us that competition almost always puts pressure on profits. If companies in a given industry are generating attention-grabbing profit margins, competitors will move in to claim a piece of the pie.

Valuation multiples can reach what appear to be absurdly high levels (over 500 for some individual stocks), but either earnings will accelerate, pushing the multiple down as the denominator in the P/E ratio increases, or the price will fall when investors realize the earnings outlook does not justify the price. In other words, an extremely high P/E ratio can be a rational expectation of future earnings growth well above historical norms, or it can be evidence of investors' collective foolishness.

Of course, markets do not behave rationally all the time, but over time, we expect stock prices to reflect the interplay between these two return drivers.

WHY U.S. EQUITIES DID SO WELL: DECOMPOSING S&P 500 RETURNS

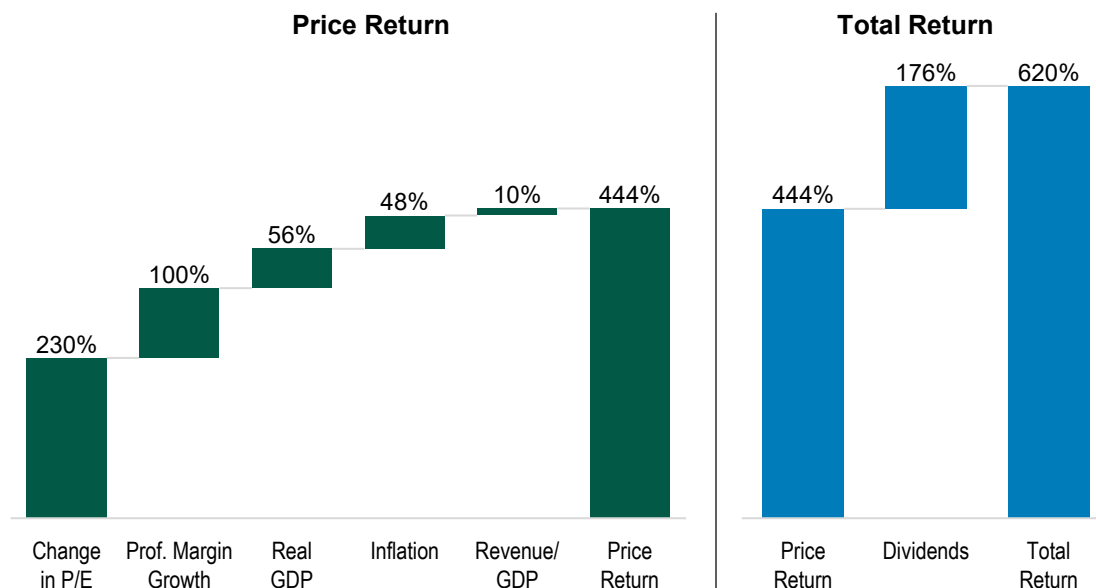
With this reasoning about the limitations of earnings growth and P/E multiple expansion in hand, it is instructive to examine the sources of S&P 500® Index returns over the 15 years following the global financial crisis (2007-2009). **Figure 1** shows this return decomposition for the S&P 500. We use returns beginning on December 31, 2010, to avoid the rebound from the 2008 bear market, using 2010 EPS, GDP and revenue as our starting point. If we had used 2009 as the starting point, the numbers would be even more dramatic.

The S&P 500 rose from 1,257 at the end of 2010 to 6,845 at the end of 2025, for a price return of 444%. To get to total return, we must add the effect of reinvested dividends, for an additional 176% over the entire period.

FIGURE 1

Rising Valuations (Change in P/E) and Profit Margin Growth Have Been Key to U.S. Stock Returns

Panel A: Sources of S&P 500 Return from 2011-2025 (Cumulative Basis)



Panel B: Sources of S&P 500 Return from 2011-2025 (Annualized Basis)

Source	Contribution To Return	Sum of Contributions
Change in P/E	4.0%	4.0%
Profit margin growth	2.7%	6.7%
Inflation	2.6%	9.4%
Real GDP	2.2%	11.6%
Revenue/GDP	0.3%	12.0%
Dividends	2.1%	14.1%

Data for both panels from 12/31/2010 - 12/31/2025. Source: FactSet, Federal Reserve Bank of St. Louis, American Century Investments.

A CLOSER LOOK AT MARGIN AND MULTIPLE EXPANSION

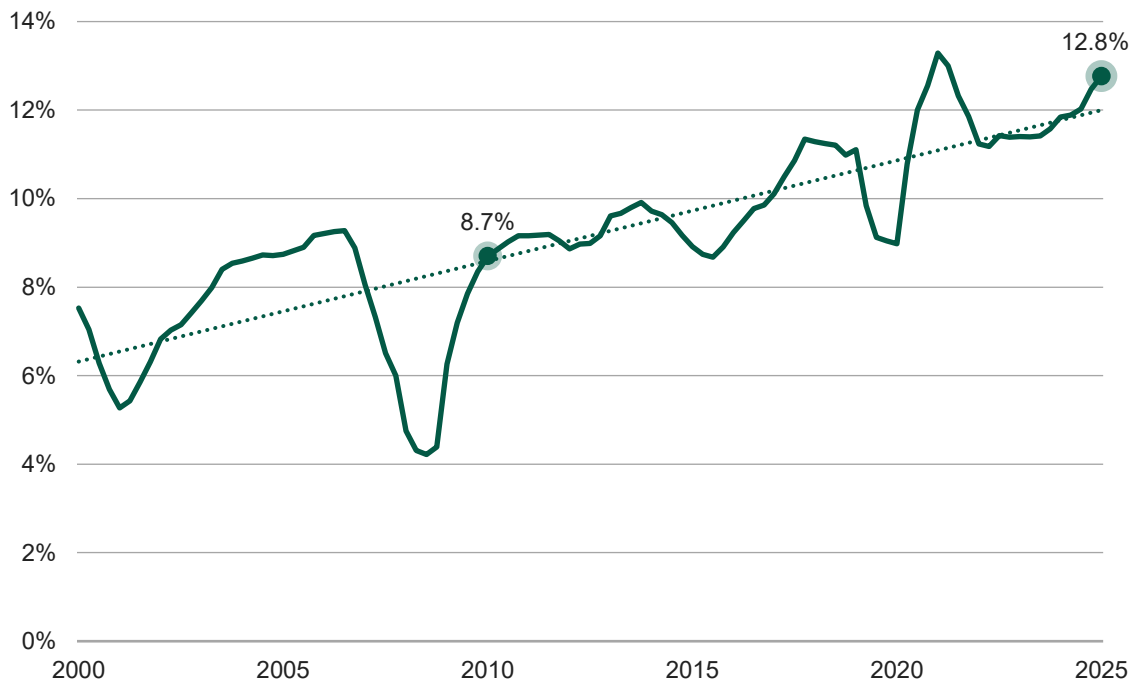
In Figure 1, we examined the sources of equity returns. Keeping in mind our formula that decomposes these returns, we see that revenue growth was very much in line with nominal GDP growth, at about 5% per year, and half that in real (inflation-adjusted) terms. Margin expansion also made a big contribution — EPS would have been 30% lower if profit margins had not grown.

As Figure 2 shows, profit margins for S&P 500 stocks are now at their highest level in at least 25 years (except for a sharp but short-lived surge during the pandemic post-lockdown period). While the trend appears to be relentlessly upward-sloping, longer-term studies show corporate profit margins declined after the 1940s until the mid-1980s.

FIGURE 2

Profit Margins Have Grown Steadily

Earnings per Share/Revenue per Share on a Rolling Quarterly Basis



Data from 12/31/1999-12/31/2025. Source: S&P Dow Jones Indices.

What Drove Profit Margin Expansion?

Why were companies able to increase profit margins from 8.7% to 12.8% between 2011 and 2025? Understanding this will help us to assess whether similar growth is likely in the future. Several factors played a major role in driving that margin expansion:

- The cost of borrowing fell to near zero, allowing companies to lever up.
- The economy shifted toward “asset-lite” businesses, with the tech sector growing faster than the capital-intensive industrial and energy sectors.
- Globalization of supply chains kept input costs low.
- With inflation below target, labor costs (real wages) did not expand much over this period.

What Drove Multiple Expansion?

In addition to strong earnings growth, rising valuations (P/E multiples) had an outsized impact on the S&P 500 between 2011 and 2025. In fact, based on the cumulative data in **Figure 1**, P/E multiple expansion contributed 50% of the total price return in this period.

Why did valuations expand so much over this period? There are many hypotheses.

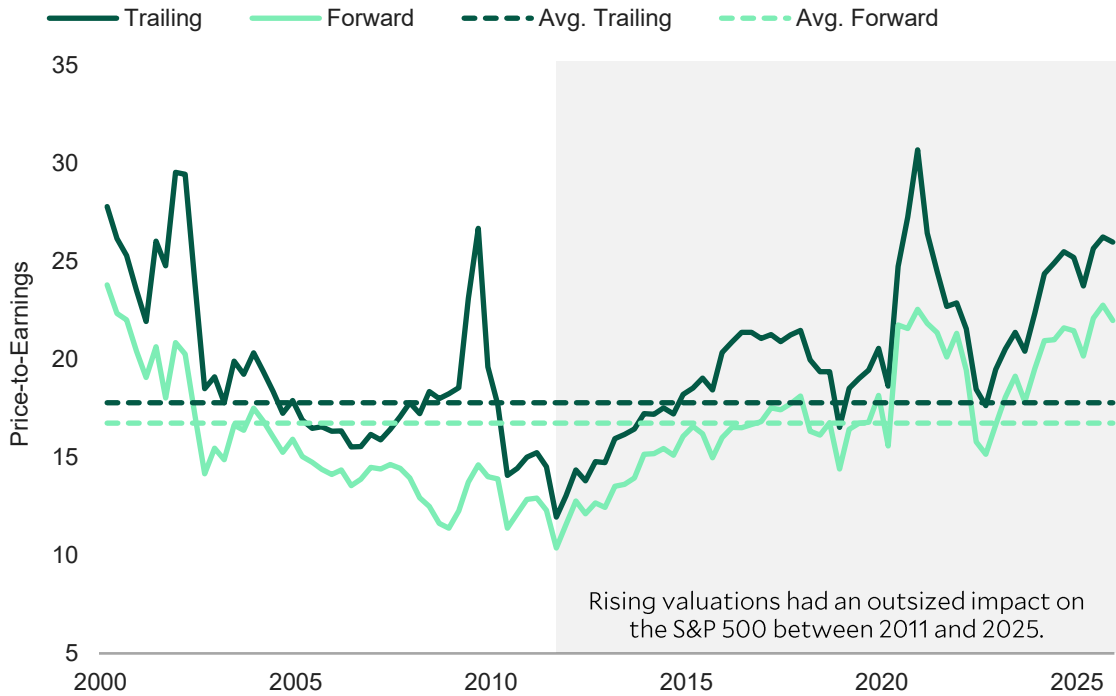
- One is that investors ratcheted up their expectations for higher EPS growth, fueled largely by the tech sector.
- Another possibility is that investors, particularly individual investors, increased their equity holdings, thus bidding up prices.
- Some might point to COVID stimulus money that may have increased flows into the stock market, but this period covers much more than the pandemic era.
- The “TINA” theory (meaning “there is no alternative”) could partly explain higher equity prices: Investors who saw U.S. equities as the only way to generate acceptable returns in a low-interest-rate environment bought more stocks.

As shown in **Figure 3**, P/E expansion accelerated as the AI theme emerged in late 2022. Since then, the market value of the “Magnificent 7” stocks has grown to nearly one-third of the entire U.S. equity market, driving multiples higher as enthusiasm for AI took hold.

FIGURE 3

Valuations Have Climbed Since 2011 and Accelerated Since Late 2022

S&P 500 Valuation Metrics



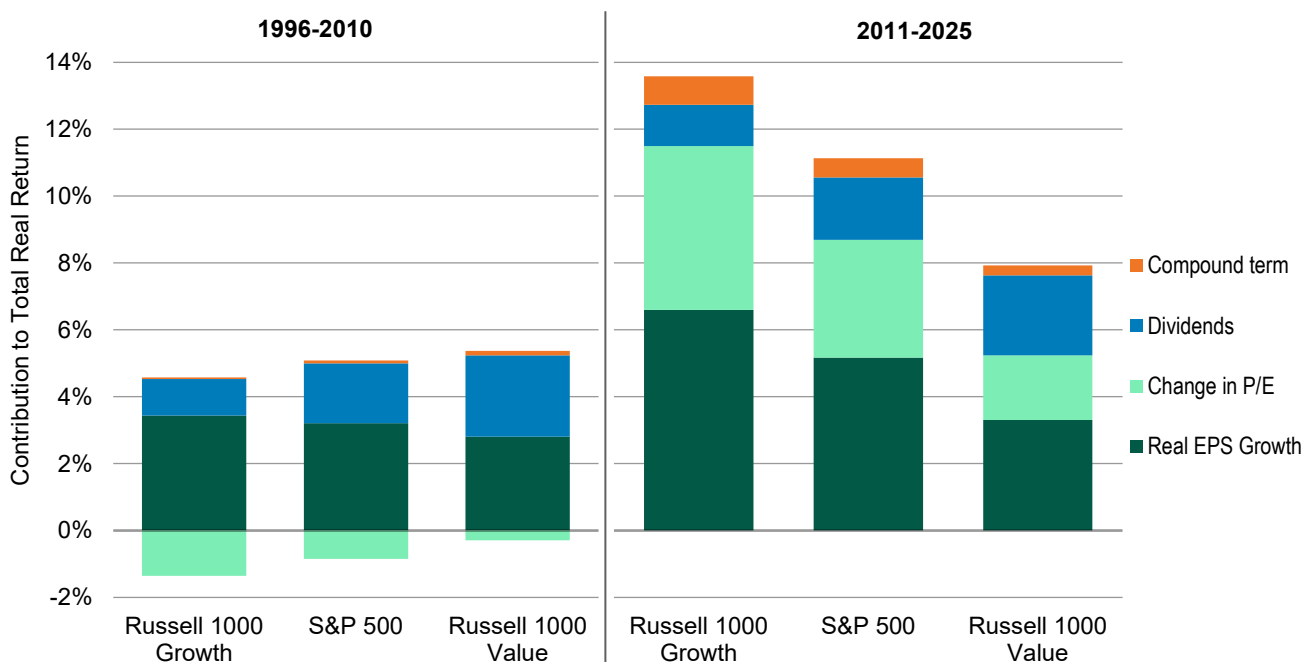
Data from 12/31/1999 - 12/31/2025. Source: S&P Dow Jones Indices, FactSet.

Separating U.S. equities into value and growth styles, **Figure 4** on the next page shows that the outsized returns over the last 15 years came from the growth part of the market, with all the points noted above regarding the overall market applying to growth stocks. Over the same period, value stocks behaved in line with long-term historical averages, with fairly low EPS growth and modest P/E expansion.

Figure 4 also shows that the change in the average P/E multiple was responsible for over one-third of U.S. growth stocks' returns in the past 15 years. In contrast, from 1996 to 2010, contracting P/E multiples detracted from annualized returns by 1.4%.

FIGURE 4

Both EPS Growth and Higher P/Es Have Propelled Real Returns for U.S. Stocks



Data from 12/31/1995 - 12/31/2025. Source: Bloomberg, FRED.

PUTTING OUR FRAMEWORK TO WORK: ESTIMATING FUTURE STOCK RETURNS

As we mentioned earlier, expecting U.S. equities to keep delivering strong returns going forward simply because they did so in the recent past overlooks the fact that market conditions and drivers can change significantly over time. Nor does it make sense to assume U.S. stocks are poised to fall just because they have been rising for a decade or more (although 2015, 2018 and 2022 were down years for the S&P 500).

Instead of changing equity allocations based on past performance and emotions, we should instead analyze what is likely to happen to the drivers of stock prices, focusing on earnings and valuation multiples, specifically.

To do so, we address the following two questions:

Question 1: Are Earnings Likely to Grow Significantly?

To address this question, we can look at how companies can boost earnings:

- Increase sales volumes without increasing costs.
- Raise prices but still sell the same level of goods or services.
- Reduce costs without decreasing sales.
- Some combination of the above.

With this in mind, we can consider the following:

Are companies likely to sell more, given the current environment?

In certain cases, such as businesses generating meaningful AI-related revenue, including “hyperscalers” that sell or lease computing resources to run AI models, chipmakers (such as Nvidia), and utilities that power new data centers, the answer may be “yes.”

For non-AI businesses — which make and sell everything else, from cars to apparel, personal care products, food, industrial components, airline tickets, restaurant meals, and so on — the ability to sell more depends on whether consumers want and can afford more. Furthermore, AI will not boost revenue overall if it results in permanently higher unemployment, which would reduce demand in our consumer-driven economy. It is possible that new jobs will be created, keeping unemployment in check, but that remains to be seen.

Do U.S. companies have room to raise prices to push earnings higher?

In other words, are customers likely to continue buying the same amount or more if prices increase? Inflation has been hurting many consumers (except the top earners), as wage increases no longer keep up with prices. In fact, many companies have resisted raising prices to offset the impact of tariffs for this reason.

Can companies reduce costs?

To generate the same output at a lower cost, prices of inputs (cost of goods sold or operating expenses) must decline, or productivity (output per unit of input) must rise. How might this happen? Tariffs increase the cost of doing business, unless a company sources 100% of its inputs domestically, which almost no publicly held U.S. company does. By definition, inflation reflects increases in costs.

Also note that over the prior decade or more, we saw a shift to “capital-lite” businesses (mostly software companies), but that trend is reversing, with these companies spending hundreds of billions, and possibly trillions of dollars, to produce computer chips and build data centers. This is pushing costs higher, not lower.

Could productivity gains boost profit margins?

Possibly! AI holds the potential for significant productivity gains going forward, but there is little evidence of this at a scale sufficient to meaningfully increase earnings in the near term. Even if we assume AI-based productivity improvements at some point in the future, a productivity J-curve¹ may slow initial progress. The longer it takes, the less it helps stock prices today.

If this detailed analysis seems daunting (and at an overall market level, it is), a simplified approach is to look at recent profit margins relative to historical averages. If recent profit margins have been historically high, they are less likely to increase further. Remember the two rubber bands? Margins cannot continue to expand indefinitely. It costs *something* to produce goods and deliver services, and as noted earlier, high margins attract competition, which tends to push profits down.

Question 2: Are Price-Earnings Multiples Likely to Move Higher or Lower?

To answer this question, consider the following:

Although valuations may look high today, remember that a high P/E multiple can be justified if we expect earnings to grow significantly in the fairly near term; fast-growing companies deserve P/E multiples that look high because their historical earnings do not reflect the current outlook. But if earnings growth is slower than the lofty P/E multiples indicate, prices must decline, or we would be in a permanent bubble.

Earnings growth in the U.S. averaged 4% for decades before rising to 6%. To justify today's P/E multiples, EPS growth would have to increase further, e.g., to 7%–8%, which seems unlikely in the near term based on the answer to question 1. As long as demand outpaces the supply of U.S. equity shares, high P/Es multiples can persist, despite sluggish earnings growth, but such momentum does not last indefinitely.

¹The J Curve is a trendline that illustrates a situation where things temporarily get worse before they get significantly better, resulting in a chart that resembles the capital letter “J”.

It is fair to ask, wouldn't the supply of public equities expand to match the higher demand? Potentially. High P/E multiples allow public companies to buy private companies with their highly valued shares, or private companies can go public at lofty prices. Furthermore, public companies could issue more of their "expensive" shares to repay debt; in other words, equity financing could become preferable to debt financing. This expansion in the supply of equity would eventually lower valuations as demand is satisfied.

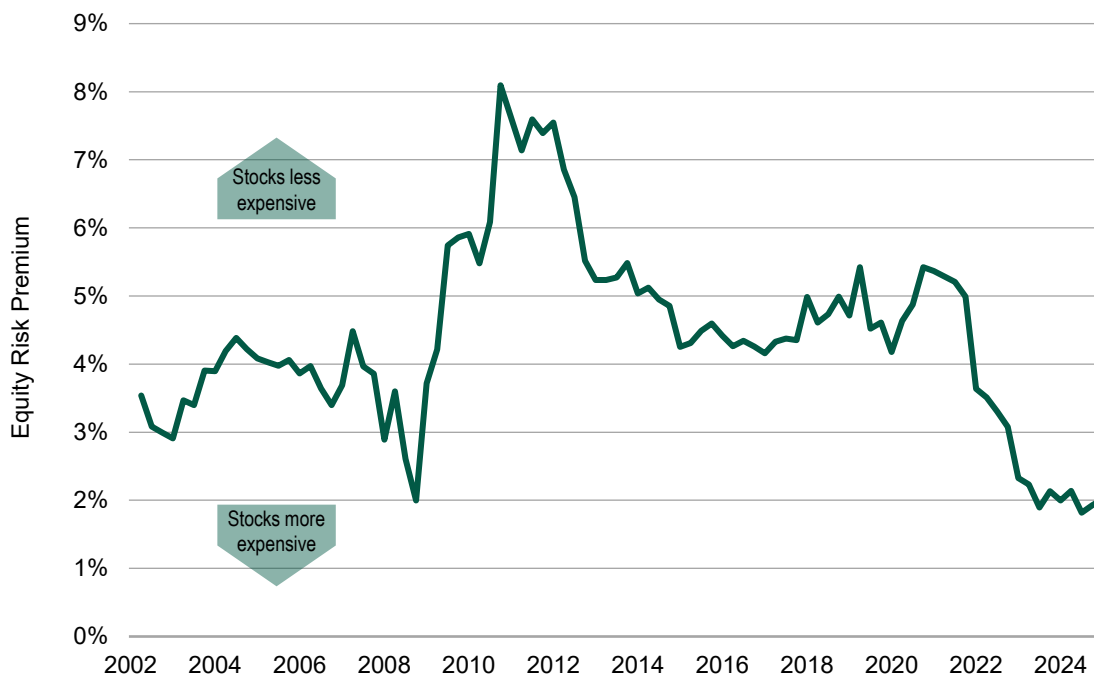
Regarding the connection between equity and debt markets, it has been proposed that earnings yields (E/P) should maintain a roughly constant spread to real bond yields, as both represent real cash-flow discounting.

With that in mind, **Figure 5** shows that the equity risk premium, or the spread between earnings yields and real bond yields, has trended toward historical lows, with stocks looking historically expensive relative to earnings and compared with bond yields.

FIGURE 5

Equity Risk Premiums Are At Historical Lows

S&P 500 Earnings Yield Minus 10-Year TIPS Yield



Data from 12/31/2002 - 12/31/2025. Source: S&P Dow Jones Indices, FRED.

PUTTING IT ALL TOGETHER: SKETCHING OUT THREE POSSIBLE SCENARIOS

While our valuation-based framework provides a better understanding of the drivers of stock returns, our outlook for profit margins and valuations remains uncertain. We see three potential scenarios for U.S. equity returns over the near term (3- to 5-year horizon).

- 1. Mean-reversion, nasty returns.** In this scenario, margins not only stop expanding but also revert to historical averages as growing competition and rising costs weigh on profits. In this scenario, we expect declining margins to bring P/E multiples down with the ship, with the potential for market cap destruction in the range of one-third to one-half of current valuations. This scenario is associated with the view that we are in an AI bubble that will burst.
- 2. Margins expand, equities on steroids.** With no theoretical limit on revenue growth, a major breakthrough in AI or other technological advancement could bring greater productivity and continued margin expansion, gradually increasing P/E multiples and strong market returns for several years.
- 3. Middle ground, slow unwind.** Margins stay roughly where they are, at historically high levels. With nothing to stretch expectations for profit growth, P/E ratios would decline somewhat to reflect lower profit forecasts. In this scenario, near-term equity returns become more volatile as multiples revert toward the long-term mean. Expectations of future profits are based on fundamentals and tangible results, rewarding profitable companies while punishing those that fail to deliver. This scenario reflects a reckoning for AI-dependent stocks whose high prices imply large, rapid profit growth, with other firms rising in value as the AI theme broadens.

Our base-case expectation for U.S. stocks is in line with Scenario 3, with a relatively benign economy in which margins remain healthy for U.S. growth stocks and revenues grow roughly in line with GDP growth. In this scenario, we expect the S&P 500's P/E ratio to decline somewhat from where it stands today.

THE CASE FOR NON-U.S. EQUITIES

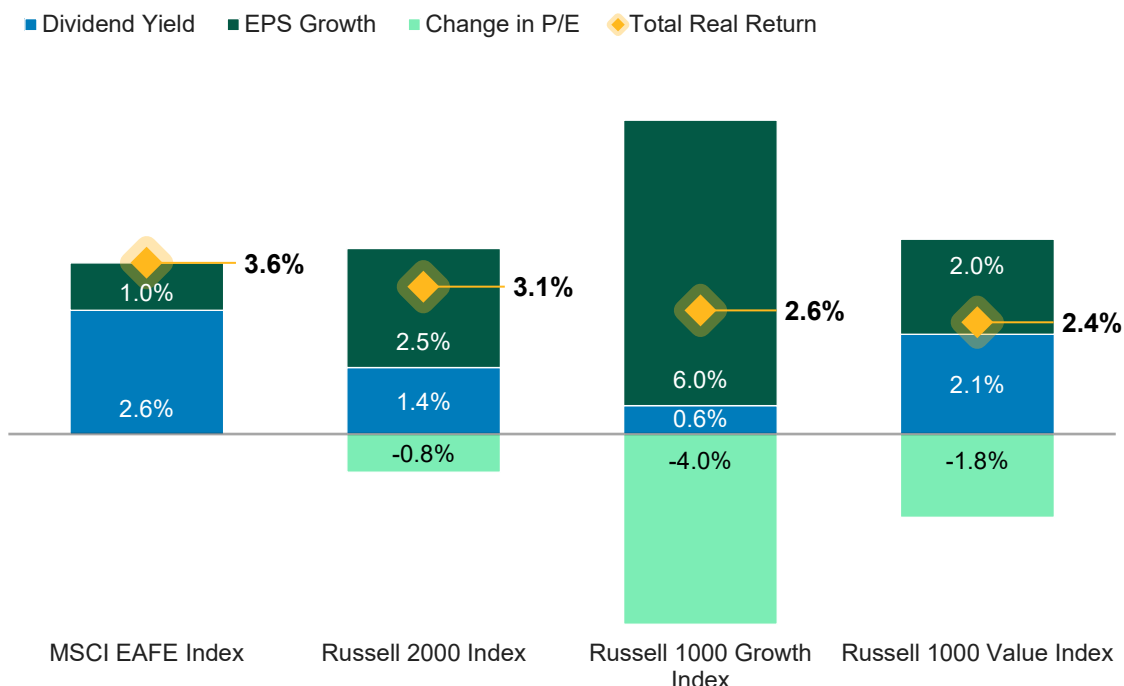
As Figure 6 shows, our forward-looking capital market assumptions for 2026 include higher expected returns from non-U.S. developed stocks and U.S. small-caps than from U.S. large-cap stocks. While EPS growth expectations remain higher for U.S. large-cap growth stocks, we see declining P/E ratios partly offsetting returns from expanding earnings.

In contrast, with less pressure on P/E multiples, we expect non-U.S. developed and U.S. small-cap stock returns to be mostly impacted by growth in earnings and dividends. In part, our outlook for European stocks is supported by growing defense spending and a willingness of at least some European governments to use fiscal policy to stimulate their economies.

FIGURE 6

We Expect Non-U.S. and U.S. Small-Caps to Outperform U.S. Large-Caps

Average Annual Real Returns Over Next 3-5 Years



Return expectations as of 12/31/2025. Source: American Century Investments.

Returns are simulated based on capital market assumptions from ACI Multi-Asset Strategies' medium-term forecasts (3-5 Years). Forecasts are not a reliable indicator of future performance. American Century Investments Capital Market Assumptions: For each asset class, American Century develops a set of assumptions for return, risk, and correlation. Because asset class returns and relationships are ultimately grounded in economic fundamentals, we forecast over various forecast horizons, including a complete economic and market cycle. We arrive at our return forecasts through various modeling techniques, such as a classic valuation approach, a risk-premium approach, and an historical risk and return analysis. In addition to this quantitative process, we employ a qualitative review, recognizing that there are elements that can't be easily captured by a quantitative process. Further, the quantitative models require forecasting various inputs, which again may contain qualitative elements.

Capital market assumptions are not meant to reflect any projection or promise of performance. No guarantee or representation is being made that any account will or is likely to achieve the assumptions shown.

For more information on capital market assumptions see: <https://res.americancentury.com/docs/comprehensive-capital-market-assumptions.pdf>.

While we believe the level of earnings growth and valuation multiples seen in U.S. large-cap stocks will diminish, earnings growth outside the U.S. has been flat over the past decade-plus and is likely to increase. In addition, P/E multiples in non-U.S. developed markets have not risen over the past decade, and GDP growth has been low (in both real and nominal terms).

This suggests non-U.S. stocks have room to move higher, particularly if government spending stimulates GDP growth, which would likely boost both revenues and profit margins. And, if the U.S. dollar continues to weaken, it would boost the value of non-U.S. stocks to U.S. investors.

CONCLUSION

Based on our analysis of the drivers of equity returns (growth in revenues, profit margins, GDP, inflation and valuation multiples), we see a supportive but moderating environment for U.S. stocks in the intermediate term, noting the outlook for U.S. equities is closely tied to AI-related developments.

We recommend maintaining exposure to the AI theme, but not at the expense of diversification, which is always an essential risk management tool. Long-term strategic allocations should align with each individual's needs and risk tolerance.

In assessing and, if necessary, adjusting a strategic asset allocation, we believe investors should look for areas of the market where price-earnings multiples and profit margins are less likely to decline. Non-U.S. markets, U.S. small-caps, and value stocks look relatively attractive under this valuation-based framework.

**In sum, rational analyses, not emotional reactions,
should dictate investment choices.**

This discussion shows how investors can make informed decisions about increasing, reducing or maintaining an allocation to stocks based on rational forecasts of the factors that drive equity returns – not irrational optimism, anxiety, regrets about the past or a fear of missing out.

Looking back at the solid returns U.S. equities delivered over the past 10–15 years, we can understand that investors may regret not having increased their equity allocations years ago; however, that may not be a reason to increase them now.

As we have done here, investors should assess how earnings growth and valuation multiples are likely to change over the next few years. And as the outlook for U.S. stocks, particularly large-caps, is closely tied to prospects for AI in the coming years, we think it is prudent to diversify beyond this theme, particularly by allocating to U.S. small-caps and non-U.S. equities.

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