

Asset Allocation Insights

Asset Allocation Through the Eyes of a Bottom-Up Investor

Key Takeaways

- **U.S. Equity Concentration Risk:** The S&P 500 Index's extreme reliance on five mega-cap tech names (30% of the Index) creates significant downside risk for passive investors. Historically, current P/E multiples of 25-27x have preceded modest or negative three-year annualized returns, making a strong case for active, value-oriented selection.
- **International Valuation Gap:** International and emerging market equities currently trade at a substantial discount to the U.S. and offer more diverse growth drivers. Governance reforms and a weakening U.S. dollar could provide additional tailwinds.
- **Fixed Income Resilience:** Starting yields of 4.3% offer strong return prospects and can act as a critical buffer against price volatility. With credit spreads at multi-decade tights, we favor high-quality securitized assets over chasing yield in expensive corporate credit.
- **Tactical Risk Management:** We are actively reducing portfolio sensitivity to broad market declines by using tools like S&P 500 futures and shifting toward defensive sectors like Health Care and Utilities. This helps us to capture gains in high-conviction stocks while mitigating the impact of a potential broad-market correction.
- **Discipline Through Rebalancing:** Historically wide valuation gaps warrant disciplined rebalancing toward lagging asset classes. Investors can conduct a "concentration audit" to ensure passive drift hasn't pushed their risk profile beyond their actual tolerance.

To see the forest, we study the trees. We believe the most insightful top-down views come from stitching together bottom-up research of individual companies and securities and analysis grounded in valuation. This fundamental approach is the anchor for our asset allocation views. As patterns emerge across sectors and regions, they sharpen our perspectives on relative opportunities.

In this paper, we share our current insights on the relative attractiveness of asset classes in our investment universe and portfolio positioning considerations.

U.S. Equities: High Market Concentration and Full Valuations

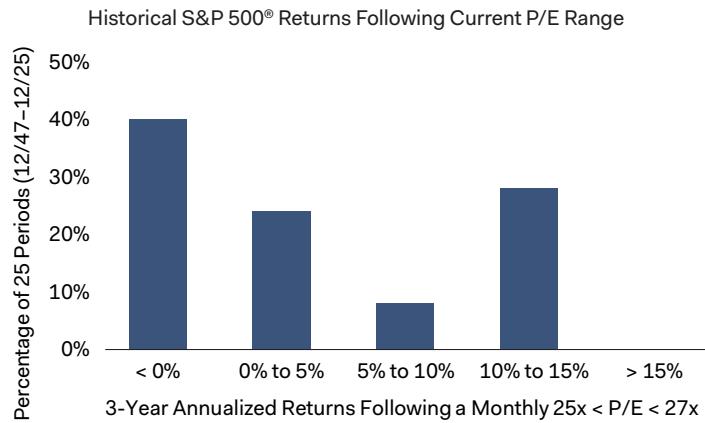
A handful of mega-cap technology and communications companies, boosted by excitement around artificial intelligence, have driven U.S. equity market returns since the end of 2023. NVIDIA, Apple, Microsoft, Alphabet, and Amazon—the S&P 500's five largest constituents—now collectively account for 30.2% of the Index, and their combined market value exceeds the stock market capitalization of every country except the U.S. and China.¹ This concentration heightens risk in passive portfolios, as setbacks in a few dominant names could disproportionately impact the Index's performance.

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In addition, the overall U.S. equity market is expensive across multiple valuation metrics, suggesting future Index returns may be more modest (see Figure 1). Since 1945, the three-year annualized returns for the S&P 500 after starting from a trailing operating P/E ratio in the current 25-27x range have spanned from -16.1% to 14.6%.

Figure 1. Higher Starting Valuations Have Historically Meant Lower Subsequent Returns²



Source: Bloomberg Index Services, S&P. Dodge & Cox calculated the percentages based on trailing operating price-to-earnings ratios in the current 25-27x range. The S&P 500's operating P/E was 26.0x on December 31, 2025.

In the past, the capital-light nature of many software and technology businesses, together with the view that many of their investments should be capitalized rather than expensed, made a credible argument that their earnings quality was high and justified higher P/E multiples. Today, given the higher capital intensity and lower revenue and profit certainty associated with AI investments, this no longer appears to be the case. In spite of, and in part due to, these characteristics of the broader market, we believe value-oriented, active portfolios have the potential to outperform.

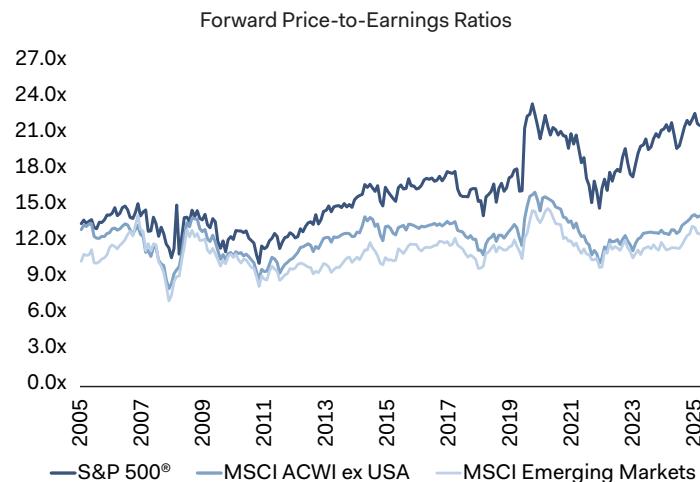
Portfolio Positioning Considerations

- Focusing on identifying attractively valued U.S. stocks:** We're still finding pockets of value in U.S. markets, but they tend to be in less cyclical sectors—such as Health Care, Consumer Staples, and Utilities—where earnings are more stable and stocks are more reasonably priced.
- Mitigating risk:** Smart portfolio construction includes risk control. By avoiding concentrated, expensive areas of the market and exposure to excessive leverage, we seek to minimize major drawdowns—an effect that can be as powerful over time as capturing gains in bull markets.
- Hedging broad U.S. equity market exposure:** Given the U.S. equity market's high valuations and heavy concentration in a few mega-cap stocks, for example, our Balanced Fund held a short position in S&P 500 futures on September 30. This position is intended to reduce the portfolio's sensitivity to a broad market decline (i.e., lower its beta) while retaining exposure to the specific securities we believe can outperform.

International Equities: Global Diversifiers at Favorable Relative Valuations

Earlier this year, we made [The Case for International Equities](#) and continue to find many opportunities there. International equities, broadly speaking, are trading at a substantial discount to U.S. equities (see Figure 2). This market provides access to different growth drivers and broader, more diverse sector and regional exposures than today's concentrated U.S. equity market. In addition, governments around the world are implementing policies—such as the Tokyo Stock Exchange's capital efficiency push in Japan, China's "Market Value Management" framework, and Korea's "Market Value Up" program—that sharpen capital returns and governance and boost long-term potential returns.

Figure 2. International Equities Are Trading at a Large Discount to U.S. Equities



Source: FactSet, MSCI, S&P. Monthly data from December 31, 2005 to December 31, 2025.

The pronounced weakening of the U.S. dollar in 2025 further strengthens the case for international equities overall, as a softer dollar can boost returns on foreign holdings and enhance the diversification benefits of investing abroad. Importantly, as discussed further below, the U.S. dollar still looks expensive on most metrics when compared to a basket of other currencies, suggesting the currency tailwinds for international equities could continue.

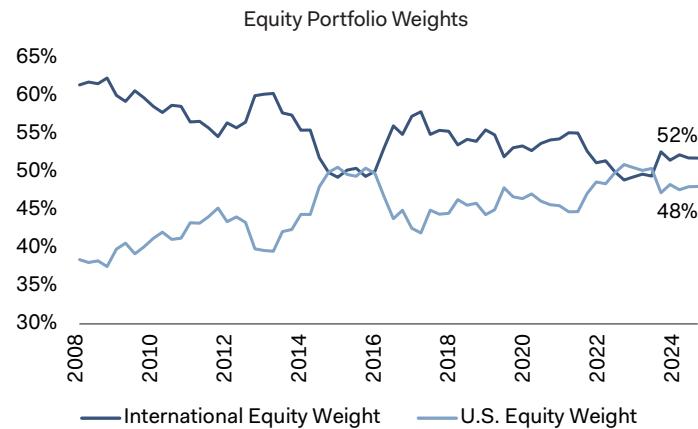
At 13.5x forward earnings, emerging market stocks look particularly compelling and offer access to higher growth potential than many developed markets due to their rapid urbanization, expanding middle class, and large, young workforce.³ Technological innovation in consumer applications, such as mobile banking, is a powerful driver in both emerging and developed markets and supports strong corporate earnings growth over time. Since their return patterns often differ from those of U.S. and other developed world stocks, emerging market equities can aid diversification, help reduce overall portfolio correlation, and potentially smooth long-term volatility.

International investing carries real risks, including currency fluctuations, geopolitical uncertainty, and the complexities of different regulatory environments. We don't dismiss these. But we believe many international stocks are priced attractively enough to offset these risks—an opportunity that's harder to find in the U.S. today.

Portfolio Positioning Considerations

- Looking to invest internationally in equities:** As shown by our Global Stock Fund's exposures in Figure 3, we're finding more non-U.S. companies with stock prices that we believe don't fully reflect the underlying business quality. Examples include: European banks trading below book value despite improved capital positions, Japanese manufacturers benefiting from governance reforms that are finally unlocking shareholder value, and emerging market companies in Asia and Latin America where structural reforms have made businesses more competitive.
- Being mindful of currency exposure:** We believe the U.S. dollar remains expensive vs. history and is likely to weaken in the coming years. To reduce unwanted foreign exchange risk, stabilize portfolio returns, and focus more on the underlying performance of the securities than currency movements, we hedge currencies on a case-by-case basis.

Figure 3. The Global Stock Fund Has Higher Exposure to International Equities

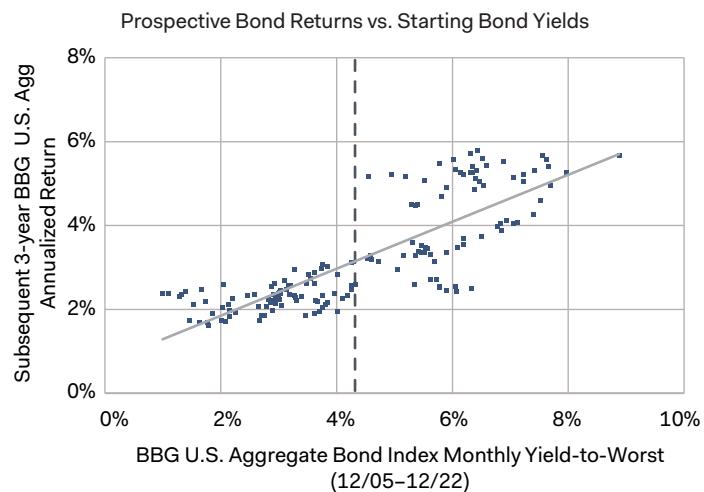


Source: Dodge & Cox. Data excludes cash and is as of September 30, 2025.

Fixed Income: Appealing Return Prospects, but Credit Spreads Are Tight

The U.S. fixed income outlook is stronger than in past years given positive real yields, lower inflation, and looser monetary policy. As front-end yields have declined, the attractiveness of fixed income vs. cash or money-market investments has increased. Starting yields have historically been a reliable predictor of future returns. Figure 4 illustrates this relationship well. Today's starting yield of 4.3% for the Bloomberg U.S. Aggregate Bond Index is attractive by historical standards and provides a buffer against price volatility from interest rate changes.⁴

Figure 4. Fixed Income Yields Are Attractive⁵



Source: Bloomberg Index Services.

Within bond market sectors, we'd note that credit spreads hover near their tightest levels in decades, amid healthy corporate fundamentals and ongoing investor demand for income. In corporate credit, the perceived current safety implied by tight spreads may not match the future reality. For example, bond investors have seen volatility in the last year from changes in tariff policies, geopolitical developments, and softer U.S. economic growth. This environment argues for continued care and discipline in fixed income allocations rather than chasing yield where investors aren't compensated for risk.

Beyond the United States, the U.S. dollar's recent weakness has prompted investors to consider adding non-dollar exposure to their fixed income allocations. We agree that global fixed income looks attractive today. We recently wrote [Global Bonds: Navigating a Weaker Dollar](#), encouraging a careful approach to currency positioning to deliver successful long-term outcomes for investors.

Portfolio Positioning Considerations

- Utilizing bonds as sources of stability and income:** The combination of higher starting yields and pockets of opportunity across sectors presents a favorable return outlook for long-term bond investors.
- Being selective in credit:** Given tight credit spreads, a discerning approach remains essential. Currently, we're focusing on shorter and intermediate-dated maturities to reduce price sensitivity if and when spreads widen. We are emphasizing issuers with durable business models and sound balance sheets.
- Investing in securitized assets:** We're finding interesting opportunities in securitized markets—Agency⁶ mortgage-backed securities and high-quality asset-backed securities—where we believe yields more than compensate investors for the underlying risks.

▪ **Rebalancing from the richest segments of the market:**

With wide valuation differentials across asset classes and regions, rebalancing is an essential discipline for investors. Motivated by more compelling yields in fixed income and less attractive prospective U.S. equity returns, our Balanced Fund has a historically higher allocation to fixed income and lower overall net equity weight.⁷ Within equities, we increased the portfolio's exposure to developed international and emerging market equities.

▪ **Analyzing correlation and portfolio construction:**

Balanced investors generally benefit from a neutral—or even negative—correlation between U.S. stocks and bonds. However, in periods of elevated inflation—such as 2022—stocks and bond prices can move more in tandem. It's beneficial to identify less correlated assets that are expected to perform better during periods of inflation, such as Treasury inflation-protected securities (TIPS).

We welcome the opportunity to discuss these perspectives and how our actively managed strategies can help you and/or your clients achieve your long-term objectives.

A Framework for Reviewing Existing Allocations

In closing, we suggest evaluating current portfolios through three lenses:

1 Concentration Audit

Has passive U.S. equity exposure drifted toward unintended concentration? Even investors bullish on mega-cap technology should confirm the weighting matches their actual risk tolerance.

2 Relative Valuation Check

Valuation differentials are wide across regions. For portfolios that have appreciated with U.S. markets, this may argue for rebalancing toward areas with more attractive starting valuations.

3 Risk Tolerance Assessment

Does the portfolio's expected downside still align with the investor's capacity and willingness to take risk? Stress tests and scenario analysis can help mitigate risk and provide signals to adjust portfolio exposures.

Balanced Fund's Top Ten Equity Holdings (as of September 30, 2025): CVS Health Corp. (2.5% of the Fund), The Charles Schwab Corp. (2.3%), Alphabet, Inc. (1.9%), Fiserv, Inc. (1.8%), GSK PLC (1.6%), RTX Corp. (1.6%), Occidental Petroleum Corp. (1.4%), Wells Fargo & Co. (1.2%), Taiwan Semiconductor Manufacturing Co., Ltd. (1.2%), and Microsoft Corp. (1.1%). Top Ten Fixed Income Issuers (as of September 30, 2025): Fannie Mae (6.1% of the Fund), Freddie Mac (5.6%), U.S. Treasury Note/Bond (5.4%), Ginnie Mae (1.8%), Navient Student Loan Trust (0.8%), British American Tobacco PLC (0.8%), Petroleos Mexicanos (0.7%), Citigroup, Inc. (0.7%), Ford Motor Credit Co. LLC (0.5%), and Charter Communications, Inc. (0.5%).

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See [Disclosures](#) for a full list of financial terms and Index definitions.

1 Unless otherwise specified, all Index weightings and characteristics are as of December 31, 2025.

2 Graph shows P/E with subsequent three-year annualized total returns, rolling monthly. S&P 500 equity analysis uses trailing operating earnings from December 31, 1944 through December 31, 2022, with the first three-year period ending December 31, 1947 and the final ending December 31, 2025. The illustration does not reflect the returns of any Dodge & Cox Fund or client account, and Dodge & Cox does not seek to replicate the returns of any index. Past performance is no guarantee of future returns.

3 The MSCI Emerging Markets Index traded at 13.5x forward earnings on December 31, 2025.

4 Measured by the Index's yield to worst, the lowest possible yield that can be received on a bond with an early retirement provision. It assumes the bond is paid off at the earliest date allowed by its terms, such as through a call or early redemption.

5 Graph shows yield with subsequent three-year annualized total returns, rolling monthly. Bond analysis uses the Bloomberg U.S. Aggregate Bond Index's yield-to-worst from January 31, 1976 through December 31, 2022, with the first three-year period ending January 31, 1979 and the final ending December 31, 2025. The illustration does not reflect the returns of any Dodge & Cox Fund or client account, and Dodge & Cox does not seek to replicate the returns of any index. Past performance is no guarantee of future returns.

6 The U.S. Government does not guarantee the Fund's shares, yield, or net asset value. The agency guarantee (by, for example, Ginnie Mae, Fannie Mae, or Freddie Mac) does not eliminate market risk.

7 Fund data is as of September 30, 2025.