CAPITAL GROUP®

Equity insights
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The age of dispersion: AI-driven shifts in U.S. equities and their portfolio implications

Martin Romo
Portfolio Manager, Chair and Chief Investment Officer

Greg Miliotes
Portfolio Manager

David Polak
Equity Investment Director

Victoria Quach
Senior Analytics Manager

- AI-driven capital spending has fueled record dispersion in U.S. equities, with smaller, value-oriented and underrepresented sectors surpassing megacap tech.
- More than 60% of the individual stocks in the S&P 500 currently outperform the index itself, year-to-date as of February 16, 2026.
- Market-cap-weighted indexes are losing effectiveness as the Magnificent Seven increasingly trade as a single tech unit rather than a diversified position, despite varying individual returns.
- Cross-sectional volatility is rising, which has historically created favorable conditions for active managers to excel through deep research and selective investing.
- Amid recent developments, advisors and institutional investors are reevaluating their allocations, increasingly pivoting toward active U.S. public equities.
- Professional allocators have many options to serve various client profiles in this shifting market.

Signs of a major change are emerging in U.S. equity markets amid a surge of AI-related spending. The transformation comes after more than a decade of concentrated gains for market-cap-weighted indexes, which pushed valuations to historic extremes thanks to a narrow group of megacap tech stocks.

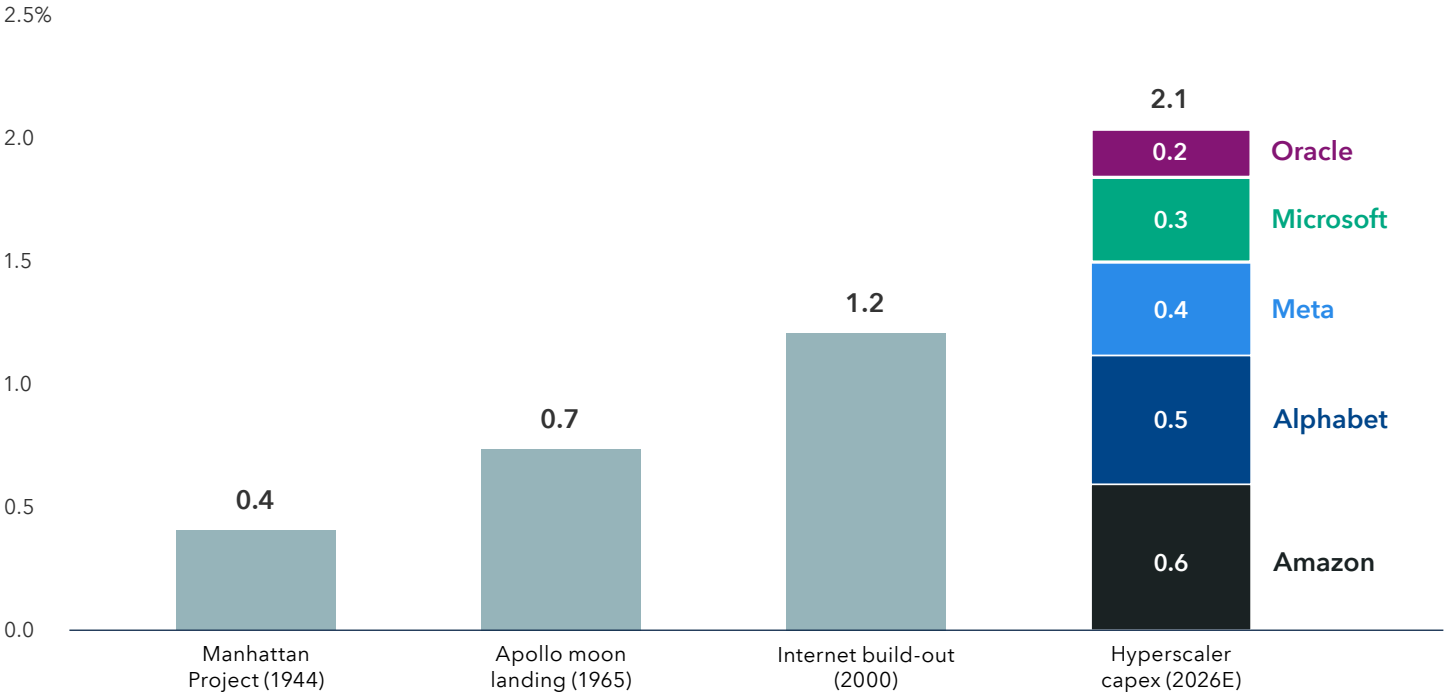
Investors are now moving into sectors and individual stocks underrepresented in these indexes, as well as the passive strategies that mimic them. Dispersion among stocks that constitute the S&P 500 Index is near multidecade highs. Previously lagging sectors and style factors like industrials and value are reasserting leadership with expectations for AI hyperscalers to drive top-line growth.

As prior trends reverse, many professional allocators are concentrating their attention on active U.S. equity investment approaches. Ostensibly, they are preparing for a more discriminating market where security selection becomes increasingly important.

We think they're right. Here's why.

Hyperscalers' capex dwarfs past spending on U.S. tech leaps

Annual investment as a percentage of U.S. GDP



Sources: Capital Group, Brookings, Congressional Budget Office (CBO), FactSet, Federal Reserve Board of St. Louis, The Planetary Society and the U.S. Census Bureau. Costs for the Manhattan Project and Apollo moon landing reflect U.S. government peak annual spending during each project's lifetime. Internet build-out reflects expenditures for equipment in the information technology sector. Hyperscalers are represented by Alphabet, Amazon, Microsoft, Oracle and Meta. Hyperscaler 2026 capex estimates are calculated by taking sell-side estimates divided by CBO GDP estimates. As of March 31, 2026. For illustrative purposes only.

AI revolution gets physical as earnings surge

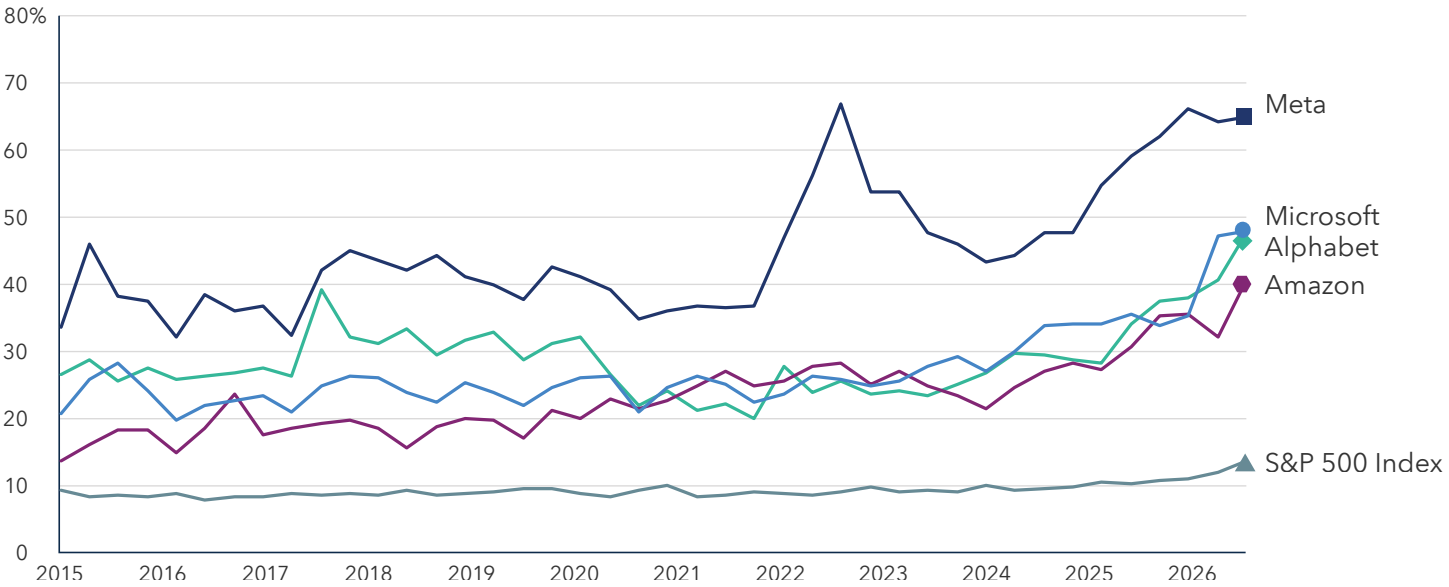
While investors initially looked to semiconductor makers and hyperscalers to capitalize on the AI boom, focus has since shifted to AI-adjacent beneficiaries. These companies could benefit from a tech-driven capex surge amid the silicon-based arms race to train AI models, deploy them at scale through inference computing and integrate them into virtual and physical (robotics) workspaces.

The tech sector's free cash flow has empowered a step-change higher in earnings expectations over the past few months. But the market appears to see through this dynamic, realizing instead of driving dividends, share buybacks or mergers and acquisitions as in the past, tech earnings could turn into top-line growth for AI-adjacent sectors via capex spending. As a result, forward price-to-earnings (P/E) valuations of non-tech sectors are perking up as prices advance ahead of earnings growth expectations.

For example, the previously out-of-favor healthcare sector led the S&P 500 in Q4 2025, when investors rotated into defensive growth names. Outside of a geopolitically driven rally in energy, industrials, utilities and materials have led this year through March. These sectors drive the enablement of the AI boom, generating and transmitting electricity to the steel and concrete data centers built with plumbing, HVAC machinery and electrical equipment that in some cases is backordered for years.

AI spending surge puts hyperscalers atop broader market

R&D and capex share of sales



Sources: Capital Group and FactSet. As of March 31, 2026. R&D: Research and development costs. Capex: Capital expenditure.

Success moving forward may depend on discernment – directing capital toward quality businesses, emerging winners and genuine bargains, while avoiding the overhyped and overvalued. This selective approach could become increasingly important if an intersectoral capital transfer accelerates in the years ahead – rotating from tech earnings via capex to asset-heavy companies anchored in tangible assets, durable cash flows and disciplined reinvestment.

Market-cap-weighted indexes face headwinds

The index-centric era culminated in a symbolic milestone in 2025, with the number of U.S.-listed ETFs exceeding the number of U.S.-listed stocks – roughly 4,300 ETFs versus 4,200 stocks according to Morningstar. While active ETFs are increasingly popular, the vast majority of these are passive products that shifted the investment conversation from *what* to own toward *how* to own it.

We believe a dramatic change in conditions is underway that will again shift focus toward individual security selection driven by fundamental research.

For one, equity valuations are historically stretched in large part because of the influence of the Magnificent Seven. The S&P 500's Shiller CAPE (cyclically-adjusted P/E) reached about 40 in late 2025 – the second-highest reading in more than 150 years, exceeded only by the 2000 dot-com peak. Such extremes have historically preceded headwinds for the index, underscoring the risks of relying solely on passive equity exposure at current price levels.

Equity market valuations near record highs

Cyclically adjusted price-to-earnings (CAPE) ratio

Source: Robert J. Shiller. Based on historical monthly CAPE ratios for the S&P 500 Index from January 1871 to March 2026. Final data point shown as of December 31, 2025. Past results are not predictive of results in future periods.

This headline figure masks a large and growing disparity between the most expensive stocks in the S&P 500 and the cheapest. Whereas the S&P 500 forward price-to-earnings multiple is currently near 22 times earnings (with the communication services and information technology sectors combining for a 23.4 times multiple), pockets of relative value abound, including financials (15 times earnings) and healthcare (18.6 times) as examples.

Active managers can pursue opportunities in these areas without the constraints of benchmark-limiting exposures.

Magnificent Seven challenges portfolio diversification

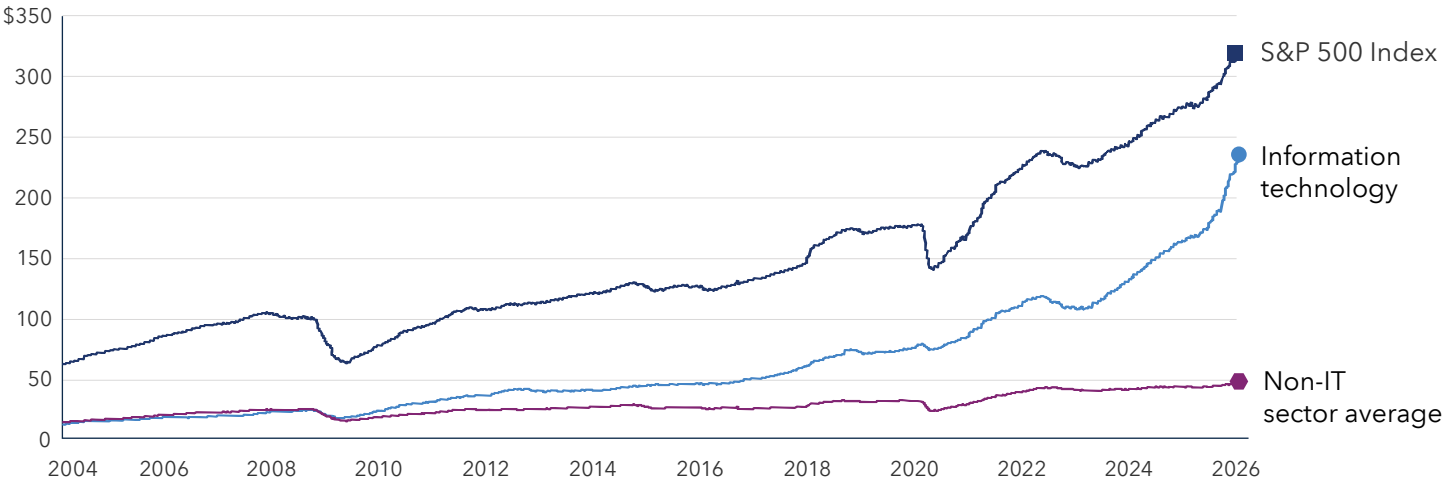
The Magnificent Seven have also been moving in ways that have challenged portfolio diversification. There are two dimensions to this: How correlated these seven stocks are to each other and how correlated they are to the rest of the S&P 500. When correlations are high, the benefits of diversification fall because these stocks increasingly trade as a single unit. In practice, owning all seven isn't providing independent streams of return but rather one giant, concentrated tech position. The key is understanding that correlation measures how two assets move directionally relative to their average return.

Compared to each other, an analysis by S&P Global Market Intelligence found the average rolling 2-year correlation among this cohort hit a high near 60% in 2024, with the highest pairwise between Microsoft and both Alphabet and Amazon.

Relative to the S&P 500 Equal Weight Index, the Magnificent Seven's correlation hit nearly 100% in the second half of 2025 before reversing into negative territory, as these stocks have significantly underperformed the average S&P 500 stock as of March 31, 2026.

Information technology earnings expectations surge

S&P 500 Index sectors: Forward earnings per share



Sources: Capital Group, Yardeni Research. Based on S&P 500 sector data from the LSEG Datastream. Forward earnings per share estimates are a time-weighted average of consensus estimates for current year and next year. Non-IT sector average is representative of the following sectors: Communication services, consumer discretionary, consumer staples, energy, financials, healthcare, industrials, materials, real estate and utilities. Data shown is from January 1, 2004, to March 4, 2026. Past results are not predictive of results in future periods.

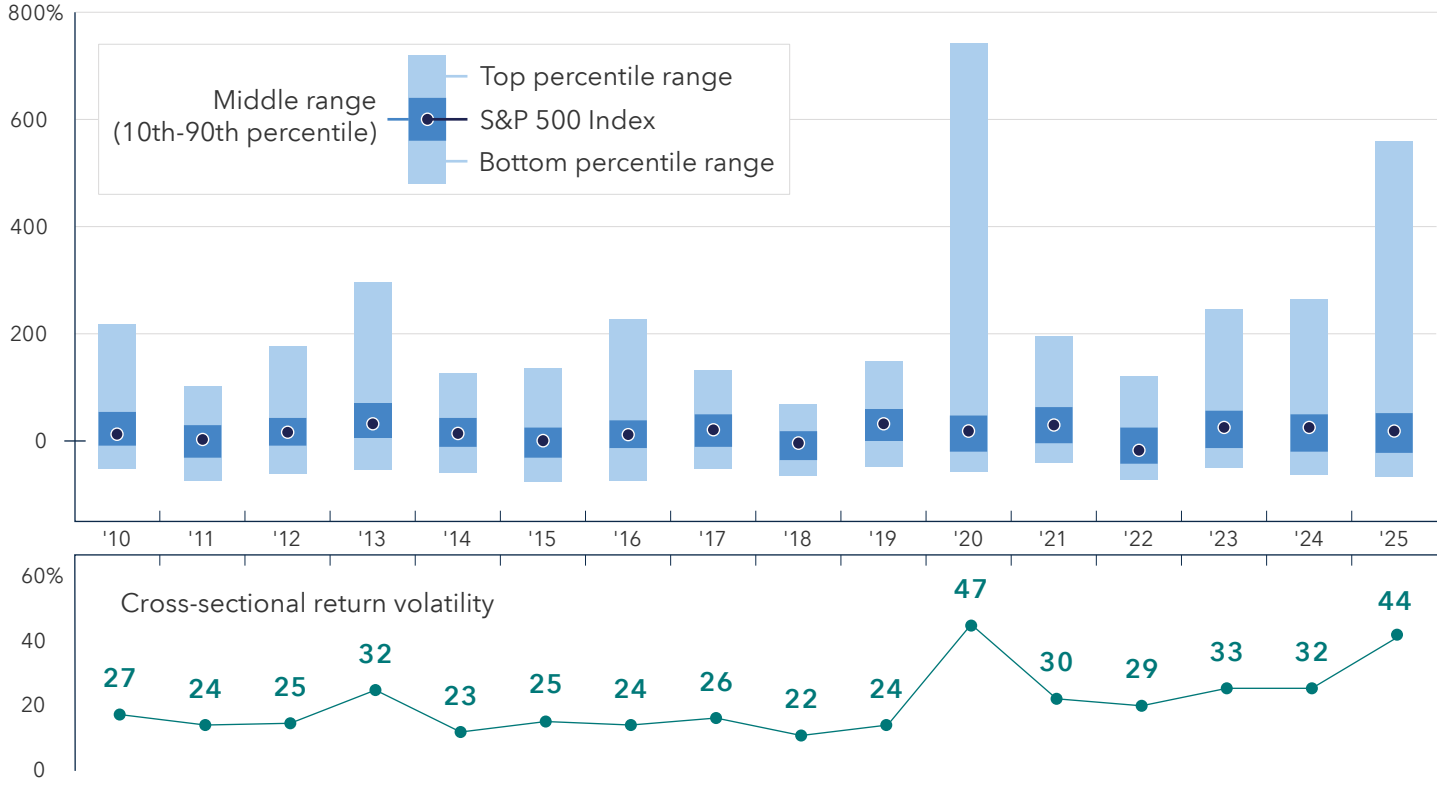
Gap widens between winners and losers

Index dispersion adds another dimension to the story, as cross-sectional volatility within the S&P 500 is returning to COVID-era highs. This indicates the gap between winners and losers is widening, indicative of mispricing opportunities that can be revealed through fundamental research and disciplined active investing.

Indeed, a 2025 analysis by Goldman Sachs found that roughly 73% of the variance in the typical S&P 500 stock's trailing 6-month return was driven by company-specific (idiosyncratic) factors, versus a 58% average for the period from 2002 through the first two months of 2025. Separately, a 2024 analysis by Morningstar found a correlation between higher return dispersion and higher active manager success rates against their benchmarks during the period studied from 1999 to 2023.

S&P 500 cross-sectional volatility rises

S&P 500 Index constituent annual total return dispersion



Source: Capital Group. As of December 31, 2025. Based on Bloomberg total return data for S&P 500 constituents. Past results are not predictive of results in future periods. Return volatility is expressed via standard deviation.

Smaller, cheaper and rising fast

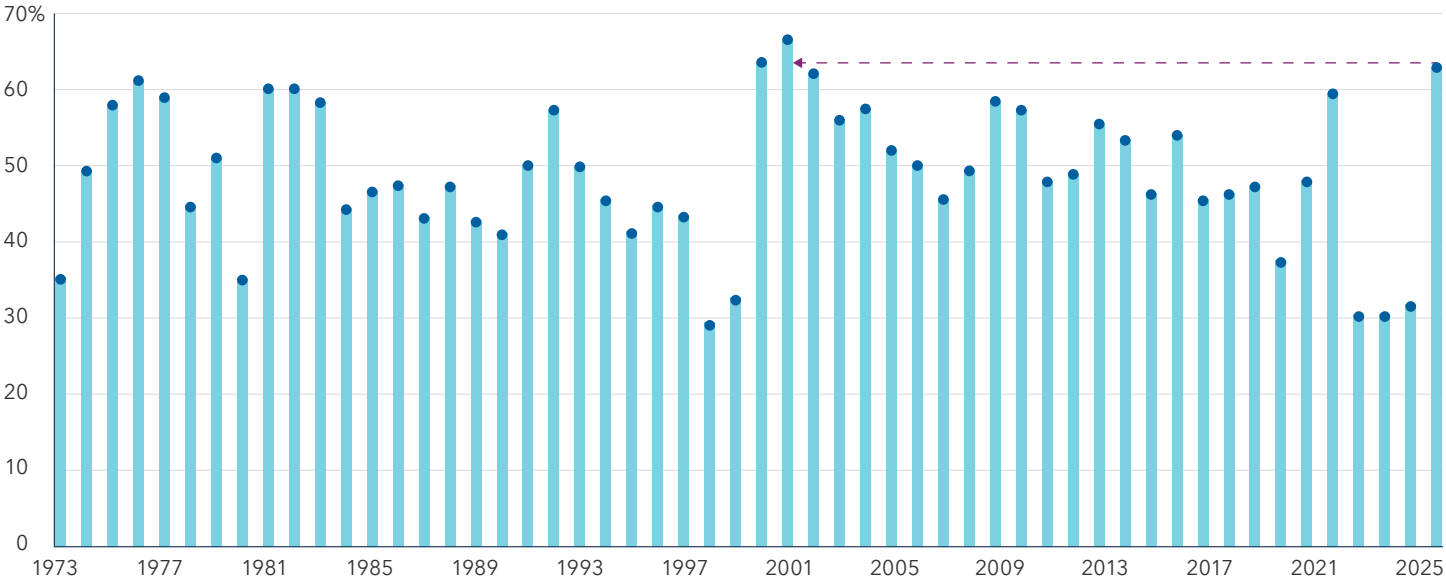
Another emerging feature of the current market is the rotation into previously underperforming segments, which may benefit active investment approaches. This dynamic can be quantified in many ways: Out of S&P 500 constituents, 62.4% outperformed the index itself as of February 16, 2026 – the highest level in more than two decades and a marked reversal from the lows seen in recent years. The Russell 1000 Value Index outpaced the Russell 1000 Growth Index by roughly 12% through the first quarter.

Small caps represent another opportunity. After years of underperformance, small-cap stocks trade at historical valuation discounts relative to large caps as of March 31, 2026. For the year to date, the Russell 2000 Index, which measures small-cap returns, outpaced the S&P 500 by more than 5%. "The valuation disconnect between small and larger stocks is one of the highest we've seen," said Julian Abdey, a Capital Group equity portfolio manager. "I believe certain small caps are poised for a comeback."

Additionally, companies are staying private longer than in past cycles, meaning today's small- and mid-cap universe includes more mature businesses with attractive valuations. This suggests the current small versus large valuation gap may present a more resilient opportunity than in prior cycles when small-cap rallies were often short-lived.

Share of individual stocks outperforming hits multidecade high

Percentage of S&P 500 Index stocks outperforming the index over a calendar year



Source: Ned Davis Research, Inc. Based on year-end data from 1973 to 2026 (year-to-date as of February 16, 2026). Past results are not predictive of results in future periods.

Rethink your allocation

The U.S. equity market seems to be entering a new phase that is causing many professional allocators to reconsider their active versus passive mix. Last cycle's formula of maximizing exposure to cheap broad market beta is being challenged by conditions of less abundant capital and greater differentiation within the asset class. This comes amid a recent reversal in excess return of the S&P 500 Equal Weight Index relative to the regular, market-capitalization-weighted S&P 500 Index.

For allocators, this implies increased active U.S. equity exposure may be warranted.

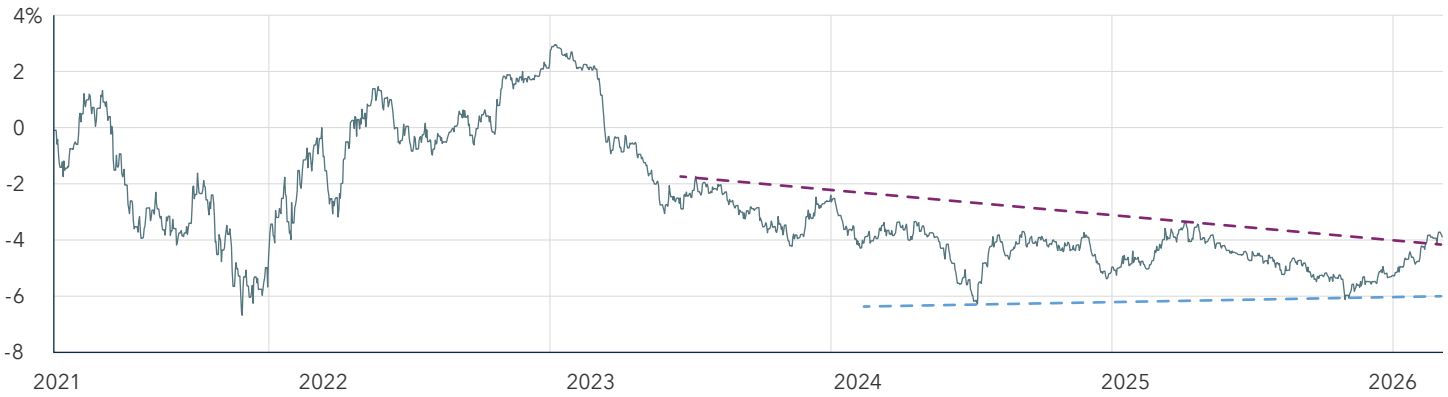
Many financial advisors are already taking this into consideration. According to a recent study from Cogent Syndicated, 27% of advisors would like to increase their active U.S. public equity exposure this year versus just 9% who are looking for more passive exposure. Moreover, 11% of registered investment advisers (who tend to be the largest proponents of passive within the advisor community) say they prefer to pivot to active U.S. public equity exposure.

Institutional investors and allocators are also reevaluating. For instance, in a 2025 Cerulli survey, 55% of U.S. pension and endowment managers agreed the current market favors active stock picking, and a similar percentage said they plan to increase allocations to active equity managers in the next 12 months, particularly in U.S. small caps and emerging markets. Corporate defined-benefit managers show a 21% net shift in allocations from passive to actively managed strategies (36% increased their active allocation, 14% increased passive allocation and 50% left the allocation neutral).

This doesn't mean "every active manager will win" or that passive index funds have no place. Rather, the broad beta of the market is unlikely to deliver as easy-to-attain gains for investors as during the 2010s. Thus, active stock and sector selection, risk management and flexibility grounded in fundamental research appear set to play a larger role in driving successful investment outcomes.

U.S. equity market broadens

S&P 500 Equal Weight Index vs. S&P 500 Index excess return



Source: Capital Group. Based on Morningstar data for the S&P 500 and S&P 500 Equal Weight indexes from April 1, 2021, to March 4, 2026. Past results are not predictive of results in future periods.

Putting it into practice

Professional allocators often face real-world concerns when increasing active exposure. A common one is benchmark risk – the potential to lag an index being used for performance comparison, such as the S&P 500, and having to explain that underperformance to clients. Cost is another worry, as is performance inconsistency – the challenge of identifying winning managers and the reality that even historically successful active funds can underperform in certain years. We must also acknowledge that idiosyncratic risk, or risk to the overall market, is now above average as well.

The good news is that these concerns may be mitigated.

According to a 2024 Morningstar report, fees for active funds dropped from 0.83% to 0.34% between 2005 and 2024, saving investors billions. This drop further narrowed the gap with passive products, especially with the rise of low-cost active ETFs. Allocators can use a core-satellite approach – keeping a passive index core and adding selective active sleeves – to pursue outperformance and risk management benefits while keeping overall costs and tracking error in check.

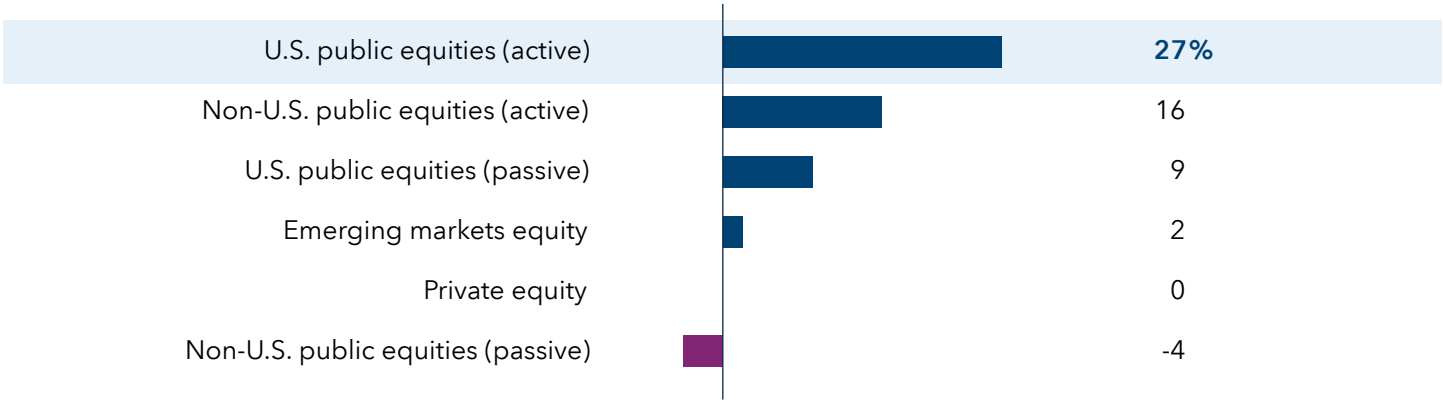
Below, we outline how different types of advisors can put this into practice.

Individual equity investor (DIY stock picker)

The key is to view active funds as complements, not replacements. Leverage high-conviction active strategies to fill gaps in coverage. The result may be a more diversified portfolio, with professionals seeking alpha in less familiar or resource-intensive niches, all while you maintain your personal investing approach.

Advisors expect to pivot into active U.S. equity strategies

Percentage share of advisors anticipating change in asset class usage over next six months



Sources: Escalent, Cogent Syndicated, Advisor Brandscape® 2025.

Direct indexer

As a practitioner of tax-efficient index replication through separately managed accounts (SMAs), you may be concerned that adding active strategies could disrupt your tax management or introduce tracking error. In practice, you may preserve your direct-indexed core – maintaining broad benchmark exposure and tax-loss harvesting – while layering in targeted active SMA allocations for incremental value. By sizing these active positions thoughtfully, you can maintain alignment with client benchmarks and risk profiles while enhancing portfolio flexibility and outcome targeting.

Low-cost beta ETF user

Cost and simplicity are often top priorities for those who primarily use index ETFs. But active managers are increasingly offering low-cost active ETFs that may deliver potential benefits and justify the incremental cost – from risk management to targeted alpha. Start small: Consider adding a sleeve or two where you see opportunity or risk that indexing can't address.

Factor-based investor

If you build portfolios around systematic factor exposures – such as value, momentum or quality – you may be concerned that traditional active funds could dilute your intended tilts or introduce unintended exposures. However, active strategies may help refine exposures, manage unintended risks and adapt to changing market conditions in ways static factor models may not. By integrating select active strategies within a factor-based framework, you can preserve your core investment thesis while adding a layer of forward-looking insight and risk management grounded in fundamental research.

The bottom line

AI-driven capex is driving broader dispersion in the market, which calls for new portfolio tactics. Fortunately, you don't have to choose sides in the active versus passive debate. By understanding your starting point and addressing the specific concerns that come with change – whether it's benchmark risk, cost or other objections – you can adopt a balanced approach.

Most allocators are already blending active and passive investment approaches to capture the best of both: the low-cost market exposure of indexing plus the alpha potential and flexibility of high-conviction active investing. The implementation strategies above offer key considerations to begin raising active allocations prudently in response to structural market changes underway.

Martin Romo *is chair and chief investment officer of Capital Group. He is also the president of Capital Research Company, Inc., serves on the Capital Group Management Committee and is an equity portfolio manager. Martin has 33 years of investment industry experience, all with Capital Group. Earlier in his career, as an equity investment analyst at Capital, he covered the global chemicals industry, mortgage and consumer financials, and select conglomerate companies. He holds an MBA from Stanford Graduate School of Business and a bachelor's degree in architecture from the University of California, Berkeley. Martin is based in San Francisco.*

Greg Miliotes *is an equity portfolio manager at Capital Group. He also serves on the Capital Group Management Committee. He has 28 years of investment industry experience and has been with Capital Group for 19 years. Earlier in his career at Capital, as an equity investment analyst, he covered U.S. diversified industrials, heavy machinery and waste companies, U.S. small-cap healthcare companies and large-cap medical technology. Prior to joining Capital, Greg was an investment analyst responsible for healthcare stock selection with RS Investments. He holds a master's degree and certificate in global management and public management from Stanford Graduate School of Business and a bachelor's degree in mechanical engineering from the Massachusetts Institute of Technology. Greg is based in San Francisco.*

David Polak *is an investment director at Capital Group, leading the team for equities and representing a number of Capital's global equity strategies. He has 42 years of investment industry experience and has been with Capital Group for 20 years. He holds a bachelor's degree in economics from University College London, graduating with honors. David is based in New York.*

Victoria Quach *is a senior client analytics manager at Capital Group, home of American Funds. She also serves on the Custom Solutions Committee. She has 18 years of industry experience and has been with Capital Group for eight years. Earlier in her career at Capital, she was a senior client analytics specialist. Prior to joining Capital, Victoria worked as a vice president at Blackrock focusing on multi-asset model portfolio construction and asset allocation. Before that, she was a quantitative research analyst developing investment strategies for tactical asset allocation and fixed income teams at Franklin Templeton Investments. She holds a master's degree in financial engineering from the UCLA Anderson School of Management and a bachelor's degree in mathematics and applied science from the University of California, Los Angeles. Victoria is based in Los Angeles.*

Glossary

Alpha: A measure of the difference between a portfolio's actual returns and its expected results, given its level of risk as measured by beta. A positive alpha figure indicates the portfolio has performed better than its beta would predict. In contrast, a negative alpha indicates the portfolio has underperformed, given the expectations established by beta.

Beta: A measure of a stock's volatility relative to the overall market, indicating how much the stock's price is likely to move in response to market changes.

Correlation: A statistical measure of how assets or indexes move in relation to each other, ranging from -1 to 1. A positive correlation close to 1 implies that when one moves either up or down, the other moves in the same direction. A negative correlation approaching -1 indicates the two have moved in opposite directions.

Earnings per share (EPS): A measure of a company's profitability, and it's commonly used in fundamental analysis. It is calculated by dividing a company's net earnings by the total number of outstanding stock shares. Forward earnings per share is an estimate of a company's future earnings per share, typically based on analysts' forecasts rather than historical results.

ETF: Stands for exchange-traded fund, a type of investment fund traded on stock exchanges that holds a collection of assets like stocks, bonds or commodities.

Hyperscaler: A large-scale cloud service provider that operates massive, distributed data centers capable of dynamically scaling computing, storage and networking resources to meet the demands of millions or billions of users.

Magnificent Seven: Seven companies (Microsoft, Apple, Alphabet, Amazon, NVIDIA, Meta and Tesla) whose stocks came to dominate U.S. stock market indexes in 2023.

Price-to-earnings (P/E) ratio: A company's price per share of stock divided by the company's earnings per share. Also known as the earnings multiple, this measure is a common tool in fundamental analysis that helps compare how relatively expensive one stock may be compared to another.

Russell 1000 Growth Index: A market-capitalization-weighted index that represents the large-cap growth segment of the U.S. equity market and includes stocks from the Russell 1000 Index with higher price-to-book ratios and higher expected growth values.

Russell 1000 Value Index: A market capitalization-weighted index that represents the large-cap value segment of the U.S. equity market and includes stocks from the Russell 1000 Index that have lower price-to-book ratios and lower expected growth values. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

Russell 2000 Index: Measures the results of small-cap segment of the U.S. equity universe. The Russell 2000 Index is a subset of the Russell 3000 Index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership.

Standard deviation: A statistical measure that quantifies the amount of variation or dispersion of a set of values from their mean.

S&P 500 Equal Weight Index (EWI): The equal-weight version of the widely used S&P 500 Index. The EWI includes the same constituents as the capitalization-weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight, about 0.2% of the index total, at each quarterly rebalance.

S&P 500 Index: A market-capitalization-weighted index based on the results of approximately 500 widely held common stocks. This index is unmanaged, and its results include reinvested dividends and/or distributions but do not reflect the effect of sales charges, commissions, account fees, expenses or U.S. federal income taxes.

Success rate: The percentage by which a portfolio outperforms a benchmark or index over a given period.

Tracking error: The standard deviation of the excess returns of the portfolio over the index returns.

Important Information

The indexes are unmanaged and, therefore, have no expenses. Investors cannot invest directly in an index.

Smaller company stocks entail additional risks, and they can fluctuate in price more than larger company stocks.

Investing outside the United States involves risks, such as currency fluctuations, periods of illiquidity and price volatility. These risks may be heightened in connection with investments in developing countries.

Passive funds are not striving to outpace their benchmarks; rather, they seek to replicate the benchmark's return pattern.

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