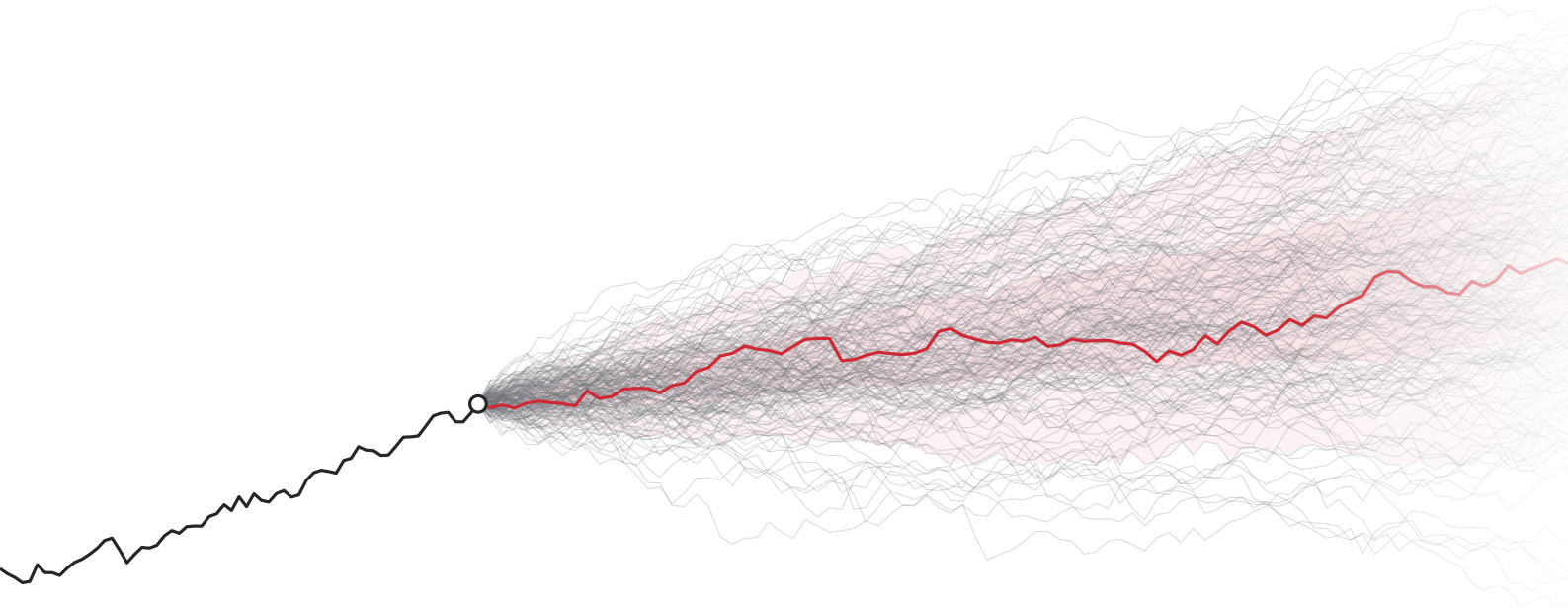
PORTFOLIO THINKING

Annual Outlook 2027

Prepare, Don't Predict: six questions for investors and their advisers in the year ahead.



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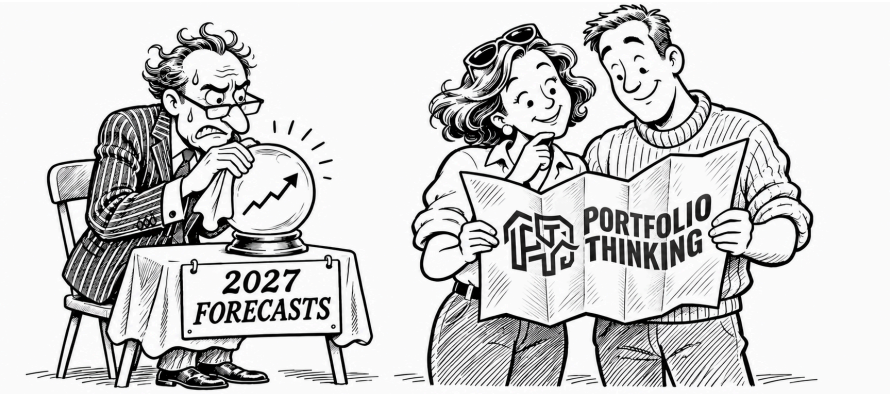
INTRODUCTION

01

Prepare, Don't Predict

Even if we could predict the news, how markets react to it is another matter entirely. Our first Outlook is built to help investors prepare for an uncertain future.



KEY TAKEAWAYS

1

Investors entered 2026 expecting lower interest rates. Instead, the attack on Iran pushed up energy prices, central banks raised rates and shares still reached new highs. Meanwhile, many strategists revised their forecasts after prices had moved rather than before.

2

Prices are a better guide than predictions. They cannot tell us what will happen next year, but they do tell us what investors are being paid to take each risk over the long term.

3

The aim is not to guess the year correctly but to build portfolios, and prepare clients, for a range of outcomes. It helps to examine the decisions investors face in 2027 and the mistakes most likely to accompany them.

At this time of year, we tend to be showered with confident predictions about the year ahead. Most will be thoughtful, well articulated and deeply researched. Many will also be harmful to our success as investors.

Forecasts are attractive as we dislike uncertainty. However, they can cause us to narrow our expectations in a way that exposes us to future mistakes. This year highlighted that problem more obviously than most.

A year few forecast

We entered 2026 with most commentators expecting interest rates to fall. However, the attack on Iran early in the year closed the Strait of Hormuz and sent the price of oil sharply higher. Rather than cutting rates, central banks raised them in an attempt to dampen the inflationary impact.

Government bond yields rose and political change was evident on both sides of the Atlantic. Despite all of this, and bouts of volatility in companies linked to artificial intelligence, shares in the largest US companies reached a series of record highs in 2026, supported by unusually strong earnings.

The forecast trap

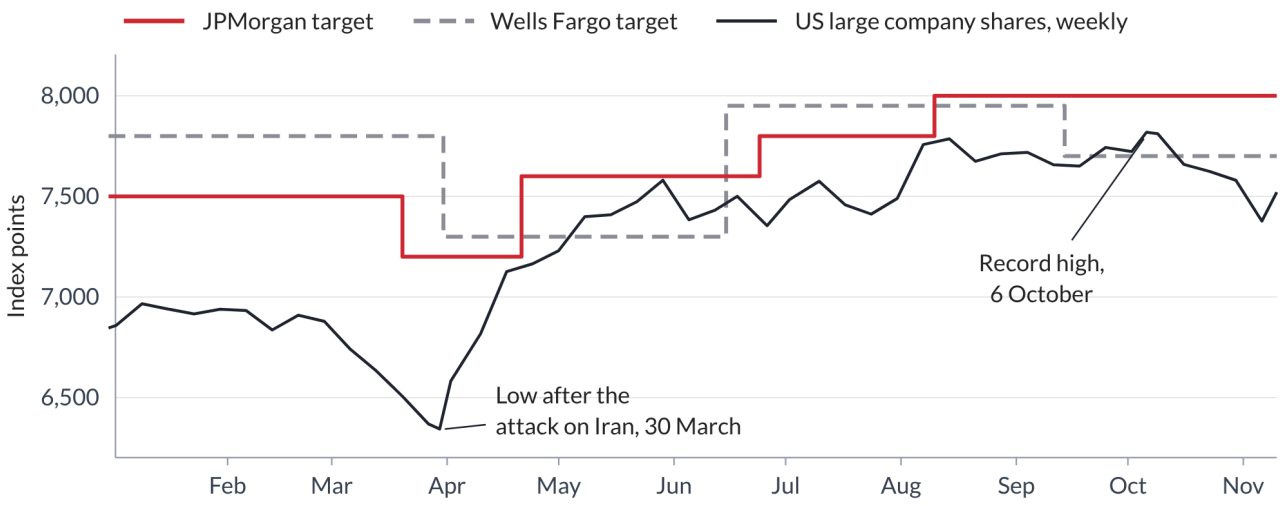
Against this background, stock market forecasters experienced severe whiplash. As figure 1 shows, strategists at several Wall Street banks cut their year end targets for US shares after the attack on Iran, close to the low in March, and raised them again as prices recovered.

An investor who followed these forecasts would have sold close to the low and bought back as prices rose, which is exactly the behaviour we try to help clients avoid. This is not a criticism of the strategists, many of whom are thoughtful and well informed. The difficulty lies in the task itself. Over twelve months, returns are dominated by events and changes in sentiment that nobody can reliably foresee, and a confident forecast encourages us to build a portfolio for a single year that may never arrive.

FIGURE 1

Forecasts followed prices

Year end 2026 targets of two Wall Street strategists for US large company shares, against the market, 2026



Source: S&P Dow Jones Indices via Federal Reserve Bank of St Louis; Bloomberg, Reuters, TheStreet.
Market level to 10 November 2026.

PORTFOLIO THINKING

Our first Outlook

This is the first Portfolio Thinking Outlook, and it is built on a foundation of fewer forecasts and more preparation. Rather than predict where markets will finish next year, this Outlook has been informed by our conversations with advisers and examines the decisions investors are likely to face in 2027. Every topic is designed to support your conversations with clients and help them avoid the predictable mistakes ahead.

The questions for 2027

We have identified six key topics for 2027. These are:

1 **Signposts, Not Satnav** 7
How should investors use estimates of future returns?

2 **Artificially Inflated?** 11
How much of a portfolio now depends on artificial intelligence and does the price reflect the risk?

3 **Have Bonds Met Their Dr No?** 15
Should investors give up on government bonds after the losses since 2022?

4 **The Best Things Come in Small Packages** 19
Where can value be found when the largest companies dominate the market?

5 **Mind the Gap** 24
Do private assets deserve a place in a portfolio, and on what terms?

6 **Built for Rougher Roads** 29
How should portfolios be built for the current environment?

Principles rather than predictions

Each article in this Outlook incorporates the following investing principles, which provide the lens through which we approach all investing questions. They were established when we launched Portfolio Thinking and both provide a consistent framework for our research and help us avoid the behavioural traps that can affect all investment decisions.

Our investing principles

1 **We put the investor first.** An outlook should be judged by whether it helps investors reach their goals, not by the attention it attracts.

2 **We practise disciplined independence.** We treat the consensus as information about prices rather than a guide to follow.

3 **We pursue value.** The price paid is a significant determinant of the return received, so our views start from today's valuations. Our expected returns are estimates, not forecasts.

4 **We focus on real risk.** The risks that matter are the permanent loss of capital, failing to meet financial goals and the erosion of purchasing power, not whether markets rise or fall next year.

5 **We take the long view.** We build portfolios to endure market cycles rather than to chase them.

What investors get wrong, and what to do instead

It is tempting to read an outlook for a prediction of next year and to act on it. A better habit is to use it to test whether each portfolio is prepared for a range of outcomes, and to agree with clients in advance what will happen when the unexpected arrives.

A year of growth

This Outlook also marks a year of growth for Portfolio Thinking. Over the past twelve months we have launched Edge, our platform for advice firms, published our first fund ratings and capital market assumptions, and begun working with advice firms in the US and UK.

None of this would have been possible without the support of our clients and the many friends and former colleagues who have offered advice and encouragement along the way. We are enormously grateful to all of you.

As we enter 2027, there is no doubt that we will once again face booms, panics and surprises that no outlook anticipated. We are equally confident that owning high quality assets at sensible prices, in portfolios prepared for more than one outcome, will continue to serve patient investors long after the headlines of 2027 are forgotten.

Dan & Neil

Founders, Portfolio Thinking
November 2026

02

Signposts, Not Satnav

Capital market assumptions point the way.

KEY TAKEAWAYS

1

Capital market assumptions are signposts, not a satnav. They point in a direction and may change at the next junction, but they cannot tell us the route or when we will arrive.

2

Small differences between expected returns are usually noise. The ranking of assets, and the range of outcomes behind each estimate, matter far more than any single number.

3

As gilt yields have risen, the reward for taking risk has shrunk. On our estimates, gilts are priced to return more than most major stock markets over the next decade.

Capital market assumptions are one of the most useful and most frequently misused tools available to investors. A long term return estimate for each asset is essential to understanding the likelihood of reaching an investor's goals. They can also help identify attractive opportunities and mitigate the greatest risks.

Used well, they act like signposts on a journey. They point the way but tell us little about the road ahead: its bends, its hills or how long it will take. They are not a satnav, and they will not steer us around every traffic jam. As the journey continues and we reach the next junction, the signposts may point in a different direction.

We can ignore them, but the journey is likely to be more difficult. Following them will not remove the surprises along the way, but it should reduce them.

How our signposts are made

There are many coherent ways to build capital market assumptions, and they can reach quite different answers. Consequently, what matters most for those who use them is to understand how they are built and how they are meant to be used.

Ours assume that asset prices are more likely to return towards their long term average levels than for today's anomalies to persist. They further assume that earnings growth, profit margins and the return companies earn on their shareholders' capital also return towards their long term averages.

This has a sound history as a starting point for investing, since unusually high profits tend to attract competition and unusually low ones tend to force change. However, reversion is our starting point rather than a law. Where a market has changed structurally, the averages of the past are a poorer guide. Japan is a recent example. Governance reforms have pushed companies to return more cash to shareholders and, consequently, the returns they earn on their capital are rising relative to history. In such situations, the basic estimate can be improved through careful research.

Reversion also carries a high degree of uncertainty and is unlikely to happen quickly. Profits and valuations can stay far from their averages for many years, which is why a ten year estimate describes a direction rather than a destination.

The danger of false precision

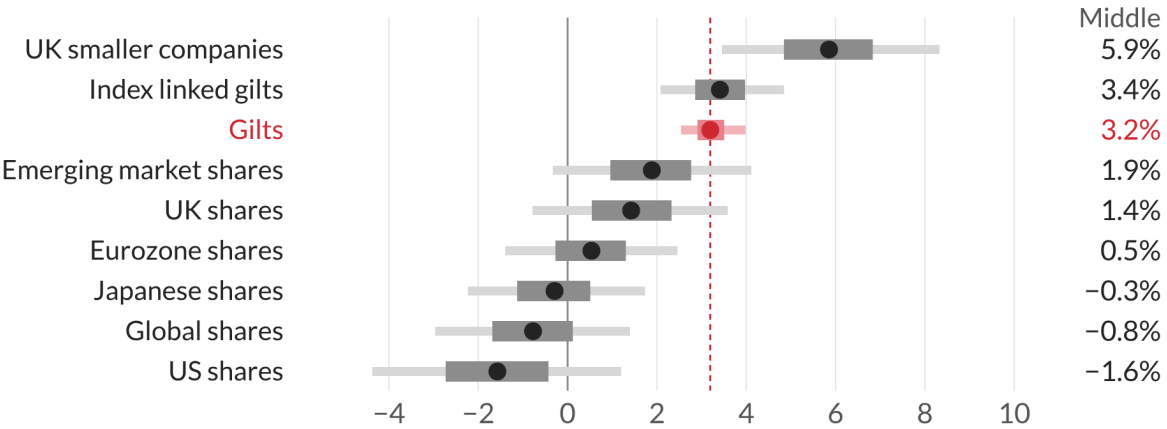
Having invested considerable time and resources in building capital market assumptions, we face a persistent danger of becoming overconfident in the numbers and too focused on small differences between them. Unchecked, this can lead us to make decisions with more conviction than the evidence justifies.

For this reason, we publish our capital market assumptions as a range of possible outcomes rather than a single average. For each asset we run thousands of simulations that vary the assumptions behind the estimate, such as how far profits fall back and how quickly prices adjust. Figure 1 shows the results. These ranges reflect uncertainty about our assumptions alone, so actual returns will vary more widely still.

FIGURE 1

Most shares are priced to earn less than gilts

Expected return above inflation, % a year over ten years, for a sterling investor



Thin line: 90% of simulated outcomes. Thick bar: the middle half. Dot: the middle estimate.

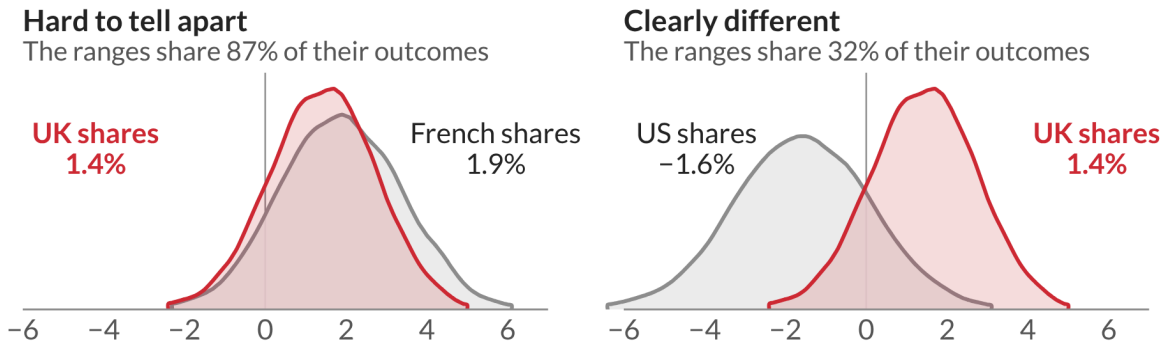
Source: Portfolio Thinking capital market assumptions, 11 November 2026.
Ranges show simulated combinations of our assumptions; actual returns will vary more widely. Estimates, not forecasts.

By comparing the ranges, we can see where our expectations for two similar assets differ, and where the outcomes overlap so much that we can have little confidence in telling them apart. As figure 2 shows, UK and French shares are almost indistinguishable on our estimates, while UK shares stand clearly apart from US shares.

FIGURE 2

Some differences are signals, others are noise

Simulated expected return above inflation, % a year over ten years, for a sterling investor



Source: Portfolio Thinking capital market assumptions, 11 November 2026. Simulated combinations of our assumptions; actual returns will vary more widely. Estimates, not forecasts.

The ranking of assets by attractiveness is therefore far more important than any single estimate, because actual returns will be driven by a wide range of unpredictable factors. It also helps to be clear about the correct use of each tool. The purpose of the suitability process is to find the right level of risk for each client. Capital market assumptions help populate the portfolio once that level is set, and give a broad sense of whether markets are rewarding investors for taking risk.

Is risk being rewarded?

One way to judge this is to compare the expected return on shares with that on assets with a defined return such as government bonds held to maturity. Accepting the additional risk of owning equities should be rewarded with a higher expected return when both are measured on consistent assumptions.

As gilt yields have risen, the environment for taking risk has worsened. On our estimates, gilts are priced to return about 3.2% a year above inflation over the next decade, more than UK shares and far more than global shares. Even the most favourable 5% of our simulations for global shares fall short of the least favourable 5% for gilts. This is not a reason to abandon shares, since the right level of risk is set by each client's goals, but it is a reason to be selective about where that risk is taken.

Reading the road ahead

US artificial intelligence companies illustrate the point. Since the launch of ChatGPT almost four years ago, they have both delivered very high growth and attracted very high valuations. Those valuations depend on that growth being sustained, which, in turn, depends on the continued building of AI infrastructure such as data centres.

The recent midterm elections showed how quickly that can be questioned. New governors in Texas, Georgia and Ohio, three of the busiest states for data centre construction, have called for pauses on new development. The risk to the buildout reduces the growth expectations of chipmakers and of the newer companies that rent out computing power, while improving the prospects of the largest cloud companies, which have been investing an extraordinary share of their cash flow in AI. Shares in the newer companies fell, while those of the largest cloud companies rose.

While we are not able to predict every twist and turn of the AI journey, we know that today's share prices assume it will be an easy one. This leaves little room for improvement and plenty of space for disappointment.

The reverse is also true. Unloved companies, priced as though their earnings will stay low, can offer very attractive returns. There is almost always a reason to be negative about them, but the probability that everything goes wrong is low, and so they can be attractive destinations for capital. The UK is a good example. Its mid sized and smaller companies have been out of favour for years, yet on our estimates they offer about 6% a year above inflation over the next decade, nearly twice what gilts offer.

> **A signpost cannot show us every bend in the road, but it can stop us heading the wrong way.**

What investors get wrong, and what to do instead

It is tempting to treat expected returns as forecasts and to act on small differences between them. A better habit is to look at the range behind each estimate, to act only where the ranges are clearly apart, and to revisit portfolios when the signposts change rather than when the headlines do.

Three ideas for portfolios

General ideas for advisers to consider against each client's objectives and circumstances; not personal recommendations.

1

Set the risk, then fill it. Agree each client's level of risk through the suitability process first, then use capital market assumptions to decide where that risk is best taken.

2

Act on clear differences, not small ones. Where the ranges for two assets overlap heavily, let cost, diversification and the client's circumstances decide instead.

3

Ask to be paid for risk. Compare what each riskier asset is priced to return with what gilts offer on consistent assumptions. Where the extra reward is thin, consider whether the risk is needed to meet the client's goals.

ARTIFICIAL INTELLIGENCE

Artificially Inflated?

03

AI will change the economy. The question for investors is how much of that change today's prices already assume.

KEY TAKEAWAYS

1

Record spending, borrowed money and circular finance lead many to ask whether AI is really an abbreviation of 'artificially inflated'. That is the wrong question.

2

The better question is how much your portfolio depends on these companies, and what today's prices already assume about them.

3

Rather than commit to one narrative, investors need to think in probabilities about the future of AI and the companies developing it.

Artificial intelligence is changing how businesses operate and how much land, power and water the economy needs. We have little doubt that it will reshape the economy. Whether it rewards investors at today's prices is a different matter.

It is easy to see why many now ask whether AI is artificially inflated. The largest cloud computing companies are expected to spend about $800bn this year, almost twice last year's total. Businesses that generated cash for years are now raising it. The largest cloud computing companies issued more than $200bn of investment grade bonds by early October, and Alphabet has announced an $80bn share issue. Newer AI companies increasingly rely on circular finance, in which chipmakers invest in or underwrite the customers that buy their chips.

Yet whether AI is artificially inflated is the wrong question. It invites us to adopt a comfortable narrative and to make predictions with misplaced confidence. The important questions are how much our portfolios depend on these companies, and what today's prices already assume.

Every boom builds too much

This is not the first technology to transform the economy. Railways, electricity, semiconductors and the internet all did. In each case, enthusiasm about long term demand led to too much investment too soon.

By 1850, investment in Britain's railway mania totalled almost half of a year's national income. In 2002, only 2% to 5% of the fibre optic cable laid in America during the internet boom was in use.

The surplus was eventually absorbed, either because demand grew to match it or because the excess capacity was destroyed. Either way, much of the capital invested was lost, through operating losses or the burden of debt. Shareholders in telecoms companies alone lost about $2tn of market value after 2000.

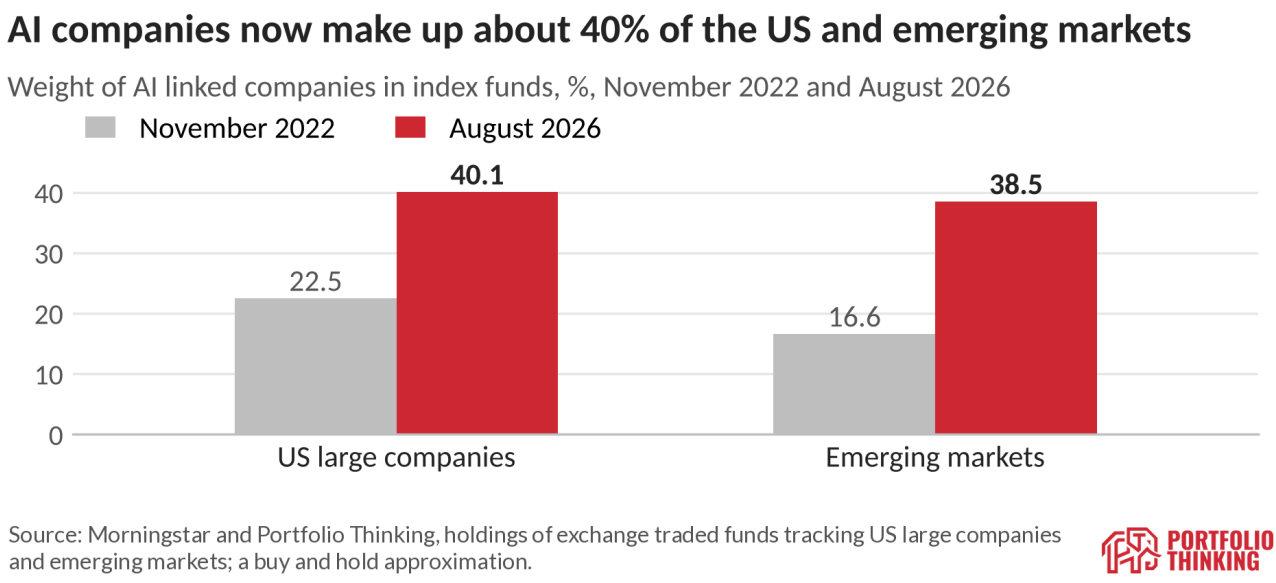
Whether the cycle repeats for AI is a fascinating debate. It matters because many of us already have substantial investments in these businesses.

The index has made its choice

Because demand for AI has grown much faster than the economy, AI companies have driven much of the recent return. On our estimates, thirteen AI linked companies contributed about 60% of the return from US large companies, in dollars, between November 2022 and August 2026. In emerging markets, TSMC alone contributed 20 percentage points of the 69% return over the same period.

As a result, AI companies now make up about 40% of both the US market and emerging markets, so owning either index has become a large bet on one theme. Adding emerging markets therefore no longer diversifies a portfolio as it once did.

FIGURE 1



Source: Morningstar and Portfolio Thinking, holdings of exchange traded funds tracking US large companies and emerging markets; a buy and hold approximation.

The concentration is still growing. SpaceX became a public company in June and joined a widely followed US index within a month. Anthropic, the maker of Claude, filed to list in October, and OpenAI, which makes ChatGPT, has said it expects to follow. Each new listing adds to the exposure of index investors.

Spending for leadership

Listing also gives these companies access to capital, which the industry needs. They are investing heavily because they expect leadership in AI to bring the outsized profits that search (Alphabet), cloud computing (Amazon), smartphones (Apple), office software (Microsoft) and social media (Meta) brought before.

Predicting a collapse would be easy, but the people running these businesses are not naive, and many have much of their own wealth tied up in them. They are unlikely to pursue an unprofitable race indefinitely, and the pace is already being tested. In October, Microsoft trimmed its spending forecast for this year, citing capacity delays, and OpenAI cut its fundraising target by a third.

Less spending would turn most of the leaders back into highly cash generative businesses. It would be harder on the chipmakers that supply them, and on newer companies with no established profits to fall back on, where capital could be lost for good.

A price like a combination lock

Good businesses are not always good investments. The returns investors receive depend both on the businesses and on the price paid for their shares, and today's prices already assume substantial growth in AI.

When SpaceX listed, our analysis found that its price needed a chain of hopeful assumptions to come good at once. Our work on Anthropic's filing suggests that even its last private valuation, about $1tn, requires revenue to grow by about 26% a year for a decade, and the company to win about 35% of a $2tn market for AI by 2036. Valuations this high behave like a combination lock: getting most of the numbers right is not enough to unlock attractive returns.

The established leaders face a bind. Cutting their spending would restore their cash flow but leave them relying on existing businesses that grow more slowly, and slower growth commands lower prices. Prices could therefore fall a long way if growth disappoints.

Our capital market assumptions allow for profitability and valuations to return towards normal levels. On that basis, US shares would return about 1.5% a year less than inflation for a sterling investor over the next decade. That is an estimate, not a forecast.

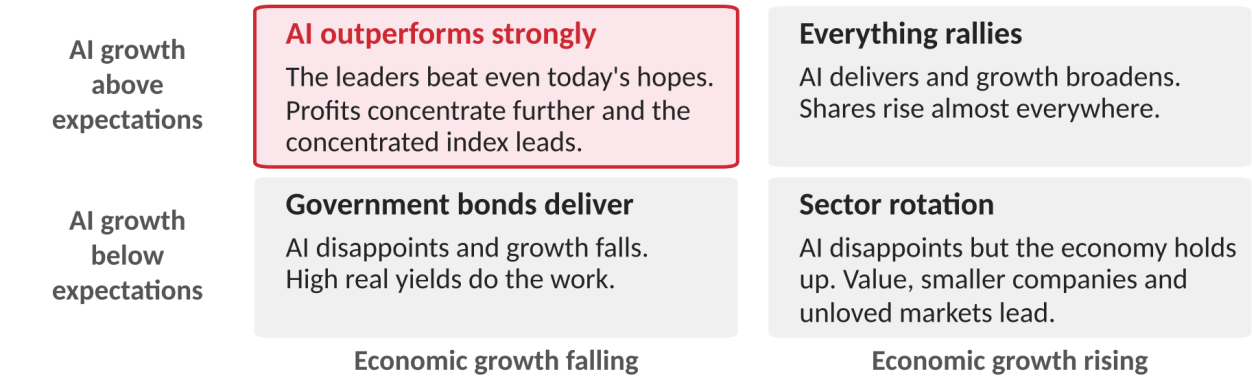
A better question

Successful investors weigh a range of possible outcomes rather than anchor on one narrative. A simple way to do this is a grid built on two questions: will AI grow faster or slower than prices assume, and will the economy grow or slow?

FIGURE 2

Four futures for a portfolio

AI growth against what prices already assume, crossed with the direction of the economy



Source: Portfolio Thinking. Illustrative scenarios, not forecasts. Highlighted: the future in which a portfolio that follows the index does best.

The important question is not whether AI will keep growing or deflate, but how your portfolio would fare in each future, and whether it depends too heavily on one of them. A portfolio that simply follows the index has become, without anyone deciding, a bet on the top left corner.

What investors get wrong, and what to do instead

It is tempting to argue about whether AI is a revolution or a bubble and to position the portfolio for the answer. A better habit is to accept that any of the four futures could arrive, check how the portfolio would fare in each, diversify so that it does not depend on any one of them, and rebalance to agreed weights at each regular review.

Three ideas for portfolios

General ideas for advisers to consider against each client's objectives and circumstances; not personal recommendations.

1

Measure the exposure, not the label. Look through US, global, emerging market and technology holdings to the combined weight in AI linked companies. It is often larger than intended.

2

Test the portfolio against all four futures. Agree with each client how success is measured, against a benchmark or in absolute terms, then check how the portfolio would fare in each quadrant, starting with its weakest.

3

Consider what depends less on AI. Smaller companies, developed markets outside the US and high quality government bonds depend far less on AI. On our estimates, the first two are priced for higher returns.

BONDS

Have Bonds Met Their Dr No?

04

Government bonds are unloved as their yields rise.

KEY TAKEAWAYS

1

A ten year gilt currently yields approximately 2% a year above expected inflation. This is unusually attractive by the standards of the years since 2008.

2

Long term inflation expectations have barely moved this year. Instead, investors demand a bigger reward above inflation for lending to governments that borrow heavily.

3

Corporate bonds pay little extra for their risk; in the US, close to the least in thirty years. Investors are being paid to lend, not to take credit risk.

High quality government bonds are the most attractive they have been in almost twenty years. A ten year gilt yields about 5.1%, roughly 2% a year more than expected inflation. Gilts of every maturity now yield well above their average since 1997, and further above it than cash.

However, they are currently being shunned by many investors concerned about the sustainability of government finances and the higher correlation of bond and share prices in the post Covid period.

At the heart of almost every Bond film is a moment when the hero appears to be finished. For government bonds, that moment came in 2022, and many investors have been saying no to them ever since. Yet the fall in prices that hurt bondholders is also what has lifted their yields to today's levels. Like the hero before the final act, government bonds have been written off too soon.

Paid to lend again

We entered 2026 with most commentators expecting interest rates to fall. Then the attack on Iran sent the price of energy sharply higher, and the Federal Reserve and the European Central Bank raised rates. In November, the Bank of England followed, raising its rate to 4%, and it now expects inflation to peak at around 5% in the middle of 2027.

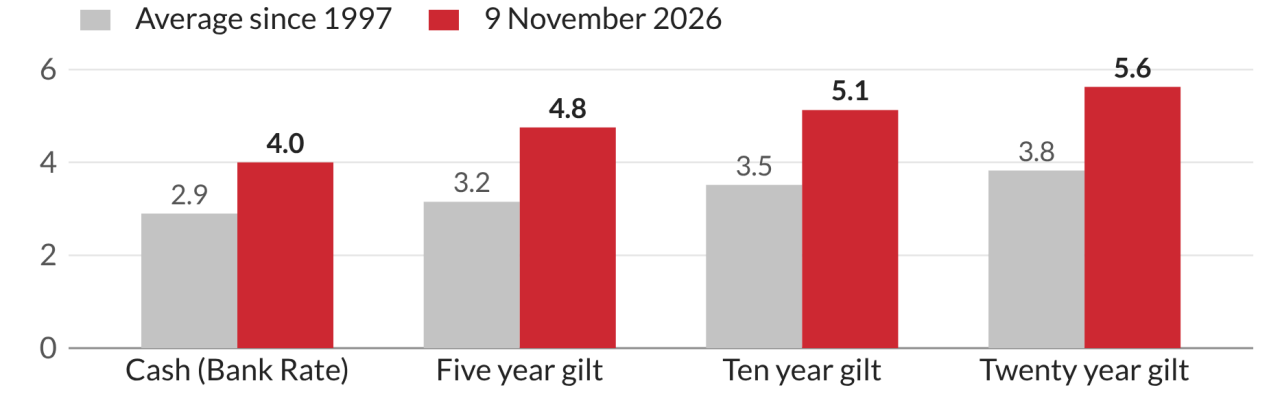
Bond yields rose, and many investors concluded that yields rose because of inflation and expect them to decline when inflation does.

The data suggests otherwise; as in any Bond plot, the obvious explanation is rarely the whole story. To understand why, it helps to split a government bond's yield into two parts: compensation for the inflation expected over its life, and the real reward for lending on top.

FIGURE 1

Gilts yield well above their long term average

UK yields, % a year: 9 November 2026 against the average since January 1997



Source: Bank of England. Bank Rate and fitted zero coupon gilt yields. Average of daily values, 2 January 1997 to 9 November 2026.

While many investors have worried about the first, it is the second part that explains the rise in yields since 2021. In both the US and the UK, the inflation investors expect in five to ten years' time is about where it was in January.

It is the real reward that has risen. In late 2021 a ten year gilt yielded 3% a year less than expected inflation. Today it yields about 2% more.

Why lenders want more

Lenders want to be paid for the same worry that is keeping many investors away: how much governments need to borrow, and how confident lenders can be of being repaid in money that holds its value.

The US ran a deficit of about 6% of national income in the year to September and now spends more on interest payments than on defence. In Britain, the gilt market has become the first judge of every Budget.

In our view, that worry is not a reason to avoid government bonds; it is the reason they now pay more. And because none of this is about oil, higher real yields may persist even when the conflict in the Middle East ends.

Higher government bond yields matter for shares too. When lending to governments pays more, every other investment has to offer more too, including shares. That is why shares and bonds can fall together when real yields rise.

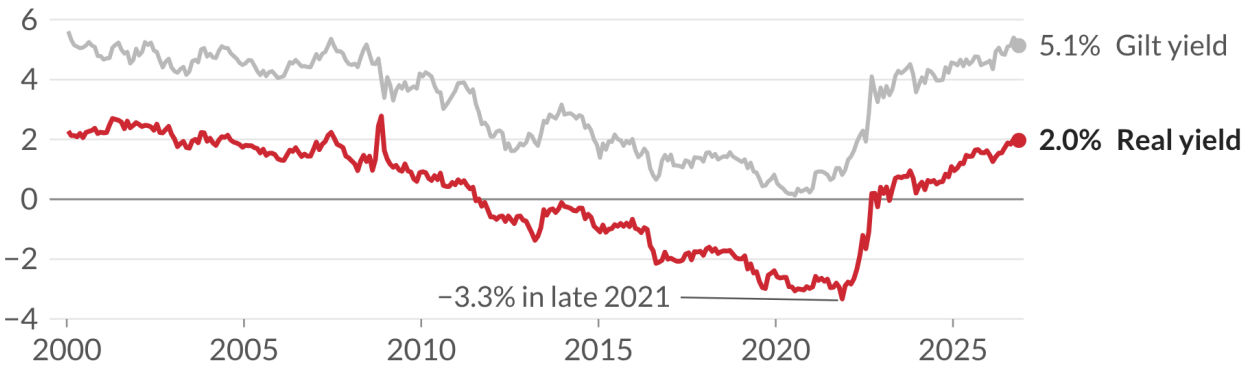
Paid to lend, not to take credit risk

The recent rise in yields does not make every bond attractive. Corporate bond yields look generous only because government yields are generous.

FIGURE 2

Real gilt yields are back near their highest since 2008

Ten year UK government bond yields, % a year, month end, January 2000 to November 2026



Source: Bank of England, fitted ten year zero coupon yields. Real yield measured against RPI inflation. Latest 9 November 2026.

In the US, the extra yield for lending to a company rather than the government is close to its lowest in thirty years: lower rated investment grade corporate bonds pay about 1.5 percentage points over Treasuries, against an average of 2.4 percentage points since 1996. On our latest estimates, sterling investment grade bonds pay about 1 percentage point over gilts, against the 1.35 percentage points our valuation work suggests is fair.

Corporate bonds also tend to fall with shares when markets are under stress, so they protect less than government bonds when it matters. In this market, investors are being paid to lend but not to take credit risk.

FIGURE 3

US corporate bonds pay close to the least extra in thirty years

Extra yield on lower rated investment grade corporate bonds over ten year US Treasuries, percentage points, month end, January 1996 to November 2026



Source: Moody's seasoned Baa corporate bond yield less ten year US Treasury yield, via Federal Reserve Bank of St Louis. Average of daily values. Latest 9 November 2026.

Taking a starring role

Government bonds tend to rise when shares fall on fears of recession, but not when the worry is inflation. That protection is now a bonus rather than the main reason to own them. In our view, a gilt's yield justifies owning it for the return alone.

So while we can be confident that bonds will defeat their Dr No, the path is never obvious and they may suffer further injuries along the journey.

What investors get wrong, and what to do instead

It is tempting to judge bonds by the losses of 2022 and to move to cash just as they pay more than they have for almost twenty years. A better habit is to write down the job the bonds in a portfolio are there to do, and to rebalance back to their agreed weight at each regular review rather than on last year's return.

Three ideas for portfolios

General ideas for advisers to consider against each client's objectives and circumstances; not personal recommendations.

1

Let government bonds earn their place. Where bond allocations were cut after 2022, consider rebuilding towards their long run weight. At today's yields, high quality government bonds can play a return role, not only a defensive one. If real yields rise further, longer dated bonds will fall in price before they mature.

2

Match maturity to need. Where a client has known spending in the years ahead, individual gilts held to maturity fix today's yield in pounds. For individuals holding gilts directly, low coupon gilts return much of their yield as a capital gain, which is free of capital gains tax.

3

Keep credit risk modest. With corporate bonds paying little extra, favour government and higher quality bonds over lower quality credit, and keep room to add when the extra yield returns towards fair value.

SMALLER COMPANIES

The Best Things Come in Small Packages

05

Smaller companies have fallen out of favour, and now look some of the best value in today's markets.

KEY TAKEAWAYS

1

Smaller companies have beaten larger ones by about 3% a year over the long run, but have lagged over the past decade.

2

On our estimates, smaller companies could return about 5% a year above inflation in the US and 6% in the UK for a sterling investor over the next decade, against about 1.5% below inflation for larger US companies.

3

Smaller companies have offered active managers better odds than the largest companies.

In our view, US smaller companies are among the most attractive options in today's stock markets. This stands in sharp contrast to the largest US companies, which are priced to offer unusually low returns after a period of rapidly rising prices and unusually high profits. However, this opportunity is easily missed, as our attention is drawn to the largest and most newsworthy companies.

Under the Christmas tree, the biggest boxes draw the eye first, and we easily miss the smaller packages that are often of greater value.

On our estimates, smaller companies could return about 5% a year above inflation in the US and 6% in the UK over the next decade for a sterling investor, against about 1.5% below inflation for larger US companies. These are estimates, not forecasts.

A premium that arrives unevenly

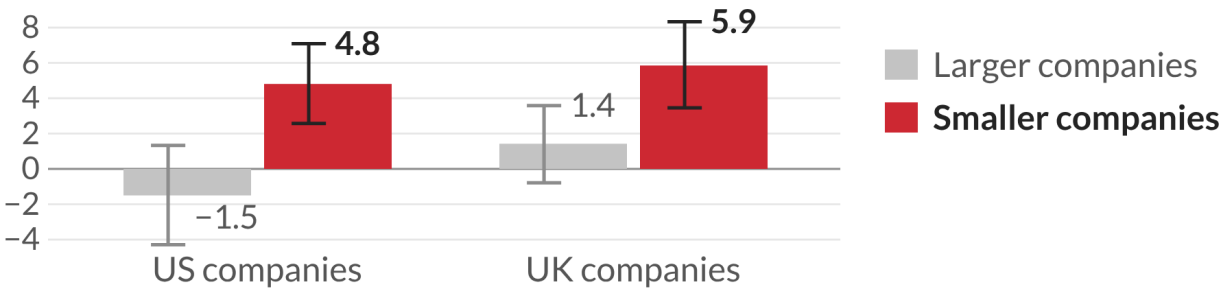
Smaller companies are typically seen as more risky than their larger peers, as they often have shorter histories, can be harder to trade and must pay more to raise capital. Consequently, their share prices tend to be more volatile.

However, investors have usually been rewarded for bearing that extra risk. Smaller companies have beaten larger ones by close to 3% a year in the US since 1927 and in the UK since 1955, which is one reason many active managers have tended to hold more in them than indicated by their benchmark index.

FIGURE 1

Smaller companies are priced for higher returns

Expected return above inflation over ten years, % a year, for a sterling investor



Source: Portfolio Thinking capital market assumptions, 11 November 2026. Lines show the 5th to 95th percentile of our estimates as model inputs vary, not the range of possible returns. US figures include currency. US smaller companies: a broad index that includes loss making companies. UK larger companies: the UK market.

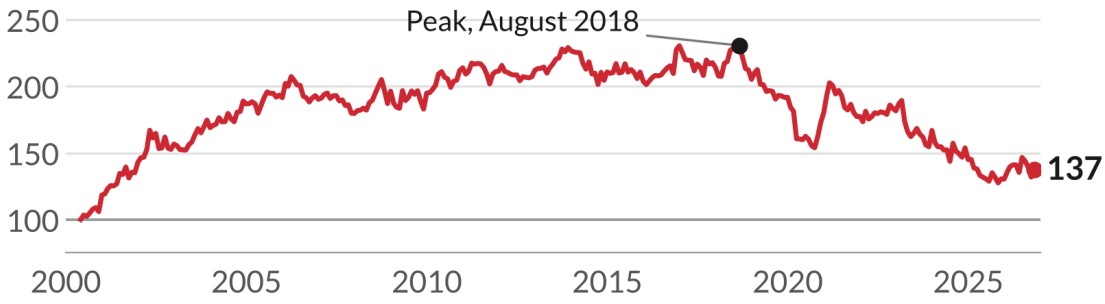
These additional returns are not evenly distributed. As figure 2 shows, smaller US companies outpaced larger ones until the mid 2000s and broadly held that lead until 2018, before giving back much of it. In the UK, smaller companies led the wider market until 2021 and have since surrendered all of the lead they had built since 2009.

Over the short term, there is some evidence of a reversal: in the ten months to the end of October, smaller US companies returned about 18% in sterling, against 12% for larger ones. However, ten good months have barely dented a decade of lagging.

FIGURE 2

Smaller US companies led for years, then lagged

Growth of smaller US companies relative to larger ones, in sterling, May 2000 = 100



Source: Morningstar, monthly total returns in sterling of funds tracking US smaller and larger company indices, net of fees, May 2000 to October 2026. A rising line means smaller companies are beating larger ones.

Why the largest companies pulled ahead

Part of the explanation is that many promising young companies no longer join the public exchanges. Increased investment in private equity and private credit funds has provided the capital a growing company needs, so it can remain private for longer.

The number of listed US companies has roughly halved since 1996, to about 3,900, and the typical company now lists at twelve to fourteen years old, against eight in the 1980s. Consequently, more of the fastest growth can happen before a company reaches the stock market and becomes available to most investors.

At the same time, money has flowed into index funds, which buy companies in proportion to their size. In the US, index funds overtook active funds at the end of 2023 and held 55% of long term fund assets two years later. Recent academic research finds that these flows lift the prices of the largest companies most.

Alongside this flow of capital, the largest companies also earned much of their gain, as profits grew rapidly through the pandemic and again with AI. On our estimates, the return larger US companies earn on their shareholders' capital has risen from about 19% in the mid 2000s to more than 35%, and the ten largest now make up about 38% of the main index of larger US companies.

Such high profits are unlikely to be sustained, and so our return expectations are grounded upon a gradual return to normal levels of profitability.

Below their usual price

The result is an unusually wide gap between the valuations of smaller and larger companies, some of it potentially warranted, some of it not. However, smaller companies are not simply cheaper than the giants: they also trade a little below their own usual price, while larger companies trade well above theirs (figure 3). In the US, smaller companies are priced at about 16 times past earnings, against an average of 17.5 since 2002, and larger companies at about 24 times, against 19.5.

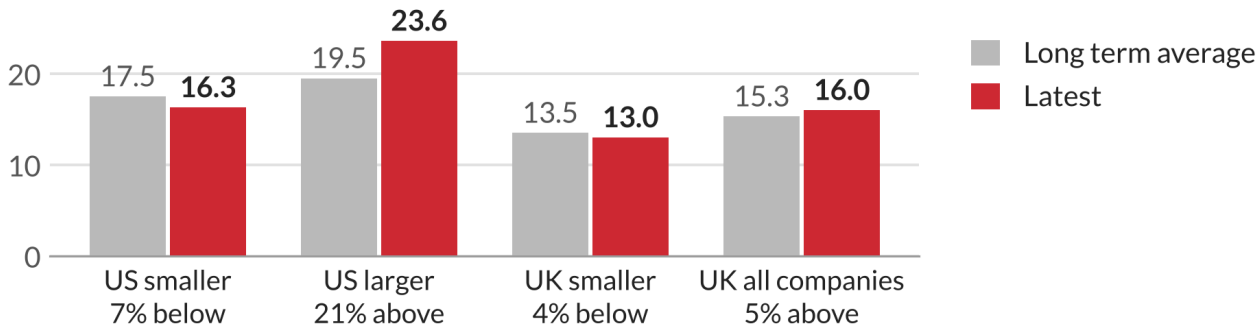
A low price is not always a bargain, but it is important to distinguish between what is scary and what is dangerous. The volatility of smaller companies can be uncomfortable, but it is the price of admission for a higher expected return. The danger lies in permanent loss of capital, which tends to be greatest among the two fifths of smaller US companies that make no profit.

The opportunity therefore lies in established, profitable businesses, many of them in traditional industries. They may never grow as quickly as the private companies that fill the headlines, but they do not need to. Our estimates assume earnings at smaller US companies grow more slowly than at larger ones, and still arrive at a higher return because the price paid for those earnings is lower. Consequently, that lower price also offers a margin of safety should growth disappoint.

FIGURE 3

Smaller companies trade below their usual price, larger ones above

Price to past earnings: latest against each group's own long term average



Source: Morningstar, price to past earnings of funds tracking US smaller and larger company indices, 31 October 2026, against the average of month end values since February 2002; loss making companies excluded. Aberforth Partners, UK smaller companies and all UK companies, 30 June 2026, against long term averages.

Low prices attract buyers

Low prices also attract buyers with cash to spend, and larger companies and private equity firms have been bidding for listed companies throughout 2026. By late July there had been more than thirty bids for UK listed companies of all sizes this year, at an average premium of 43%. In the US, a string of smaller industrial companies has agreed to be bought, two of them at premiums above 25%. For their shareholders, a takeover can deliver in a single day the recovery in price that might otherwise take years.

Owning more than the index

Index funds have been one of the greatest developments in recent decades, supporting client outcomes at very low costs. However, a portfolio does not have to mirror a benchmark. An index fund holds smaller companies only in proportion to their size, which after a decade of lagging is small. Holding more in smaller companies than the index is a deliberate choice that requires discipline, as it means accepting periods, sometimes years, when the portfolio trails the index.

Smaller companies have also given active managers a better chance of adding value than the largest companies, partly because fewer analysts study them. More than half of smaller US companies are followed by five or fewer analysts, against 1% of the largest US companies. Over the ten years to June, 29% of active funds investing in smaller US companies survived and beat their index alternatives, against 13% among larger companies.

In our view, smaller companies are where active management is most likely to earn its fee, and where we favour it, provided managers are chosen with care: even here, most fail to beat an index alternative over ten years.

Valuation tells us more about direction than timing, and smaller companies could stay out of favour for some time yet. However, in our view investors are now being paid well to wait. Those prepared to do so should find that the best things really do come in small packages.

What investors get wrong, and what to do instead

It is tempting to avoid smaller companies because they have lagged for a decade, and to read 'cheap for years' as 'cheap for good'. A better habit is to set the allocation on today's prices rather than the last decade's returns, size it so that clients can hold it through years of lagging, and top it back up to its agreed weight at each regular review.

Three ideas for portfolios

General ideas for advisers to consider against each client's objectives and circumstances; not personal recommendations.

1

Decide the weight, do not inherit it. Index weights reflect today's prices, and so the last decade's returns, rather than any view on value. Consider whether smaller companies in the US and the UK deserve more than their index weight, sized so that the client can stay invested through a long period of lagging.

2

Beware unprofitable exposures. Within smaller companies, consider established, profitable businesses rather than loss making ones. A broad index of smaller US companies holds many businesses that do not yet make a profit.

3

Use active managers where the odds are better. Fewer analysts follow smaller companies, which leaves skilled managers more to find. Most still lag over ten years, so choose with care and judge them over a full market cycle.

PRIVATE ASSETS

Mind the Gap

06

Private assets can reward patient investors. However, a poor structure can turn a successful strategy into a disappointing investment.

KEY TAKEAWAYS

1

In principle, private assets reflect good investing: a long horizon, significant ownership of businesses and freedom from the daily price movements that can tempt us into mistakes.

2

In practice, fees, valuations set by the managers who are paid on them and liquidity promised on illiquid assets can consume that reward, as hedge fund investors discovered in 2008 and private credit investors have been reminded this year.

3

Investors should set a clear expectation of returns rather than relying on past performance, understand what they own, avoid overpaying and commit only money they will not need.

Private assets have a role in some portfolios, but only when investors are properly rewarded for what they give up.

Sound principles, uncertain structures

In theory, owning private assets simply reflects sound investing principles: it is focused on the long term, allows investors to become significant owners of good businesses and is free from the daily price movements that can tempt us into costly mistakes.

However, a sound strategy does not guarantee a good investment, and the current popularity of these assets risks undermining their benefits. The situation is similar to that faced by commuters on the London Underground at peak hours, when the journey costs more, the carriages are uncomfortably crowded and it is easy to trip when entering and exiting a train. Those of us who use the Tube are constantly told to ‘mind the gap’, and investors considering private assets would benefit from a similar reminder.

The gap that matters lies between the expectations and the reality of investing in private assets, and it is seen most clearly in the difference between the liquidity a fund offers and the liquidity of what it owns. Illiquidity is not a flaw of private assets but the source of much of their reward, since investors have traditionally been offered higher returns in exchange for committing their money for longer.

Individual investors have typically been more reluctant to accept illiquidity, and consequently asset managers have sought to bridge the gap by creating products that appear to offer greater liquidity than their underlying assets. Investors have responded, and assets in US semiliquid funds, which offer to buy back a small part of their shares each quarter, approached $600 billion in March, more than double their level at the end of 2022. This enthusiasm has not been limited to the US. In the UK, Long Term Asset Funds can now be held in ISAs, and seventeen pension providers have pledged to place 10% of their default funds in private markets by 2030.

We have been here before

This is not the first time strategies promising superior returns, charging high fees and offering limited liquidity have captivated investors. After the technology bubble burst in 2000, investors sought higher and steadier returns from hedge funds, whose assets approached $2 trillion by the middle of 2008. Many reached them through funds of funds, which managed about half of the industry's assets and charged, on average, a further 1.3% a year and 7% of profits on top of the underlying managers' fees. Over the twenty years to 2010, funds of funds returned about 8.2% a year, against 12.2% for single manager funds.

In the scramble for the best managers, investors accepted lock ups and gates, while some funds of funds relied on new money and borrowing to bridge the liquidity gap. When the financial crisis arrived, the leverage in the underlying funds and in the structures above them was exposed.

The average fund of funds lost about 17% in 2008 and many suspended withdrawals. The strategies that survived later reached advisers and their clients rebadged as 'liquid alternatives', with lower fees, regular dealing and more established managers. In many cases it was the structure, rather than the strategy, that failed investors.

This year's test

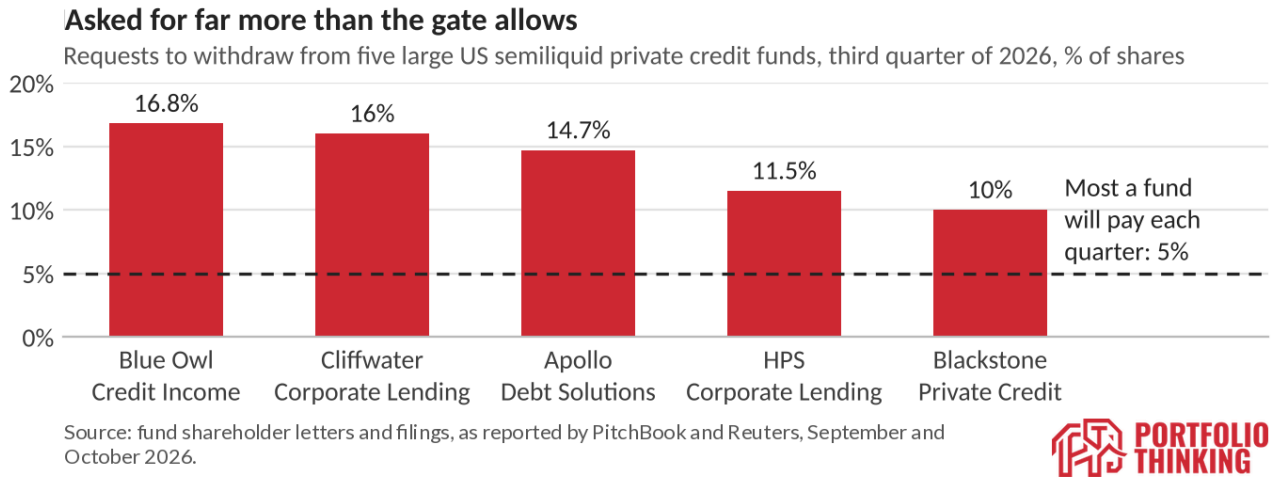
Private credit has provided this year's reminder. Following concerns about lending to software companies early in the year, requests to withdraw from the largest US semiliquid private credit funds rose far above the 5% that most will pay each quarter (figure 1).

UK investors have seen gates for illiquid assets before. Open ended commercial property funds suspended dealing after the referendum in 2016 and again in 2020. Several were subsequently closed.

Preparing for the gate

Given the challenge of illiquidity, investors must have a clear expectation of returns before investing rather than simply relying on past performance, which flatters assets whose prices are set infrequently. That expectation should start from today's yields and valuations and deduct likely losses and every layer of fees.

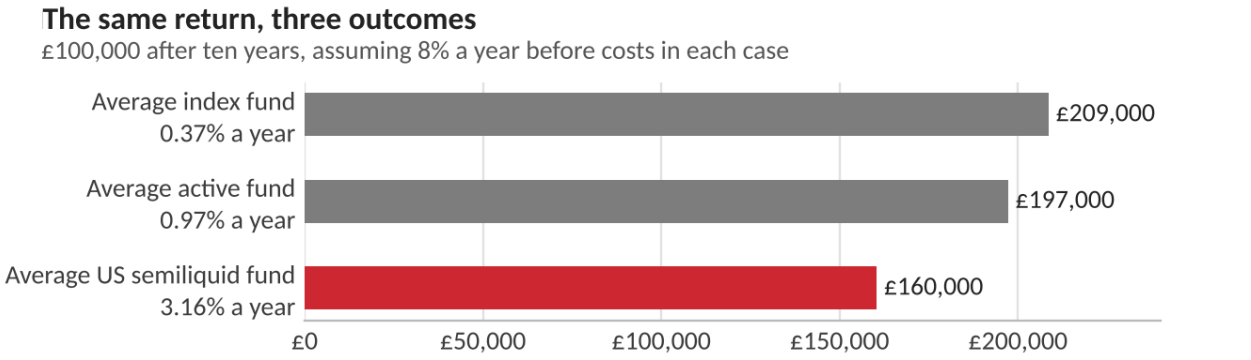
FIGURE 1



Source: fund shareholder letters and filings, as reported by PitchBook and Reuters, September and October 2026.

Costs matter more here than elsewhere. Morningstar found that the average US semiliquid fund charged about 3.2% a year, against 0.4% for the average index fund, and only four of the nineteen such funds it rated earned a positive rating of Bronze or Silver. On the same return before costs, that difference compounds into a very different outcome (figure 2).

FIGURE 2



Source: Morningstar, The State of Semiliquid Funds 2025, average net expense ratios. Hypothetical illustration; ignores tax and dealing costs.

Know what you own

Next, we need to understand the variety beneath the label. Private equity, venture capital, direct lending, infrastructure and property carry very different risks, and two funds with the same label can own very different assets.

Even within private credit, the quality of the underlying loans deserves close attention. Fitch's measure of US private credit defaults reached a record 6.3% in the year to September. The credit ratings attached to such loans also require greater scrutiny, as many are private ratings that are neither published nor widely tested. A Columbia Business School study found that privately rated bonds held by US life insurers were more likely to suffer impairments than publicly rated bonds with the same rating.

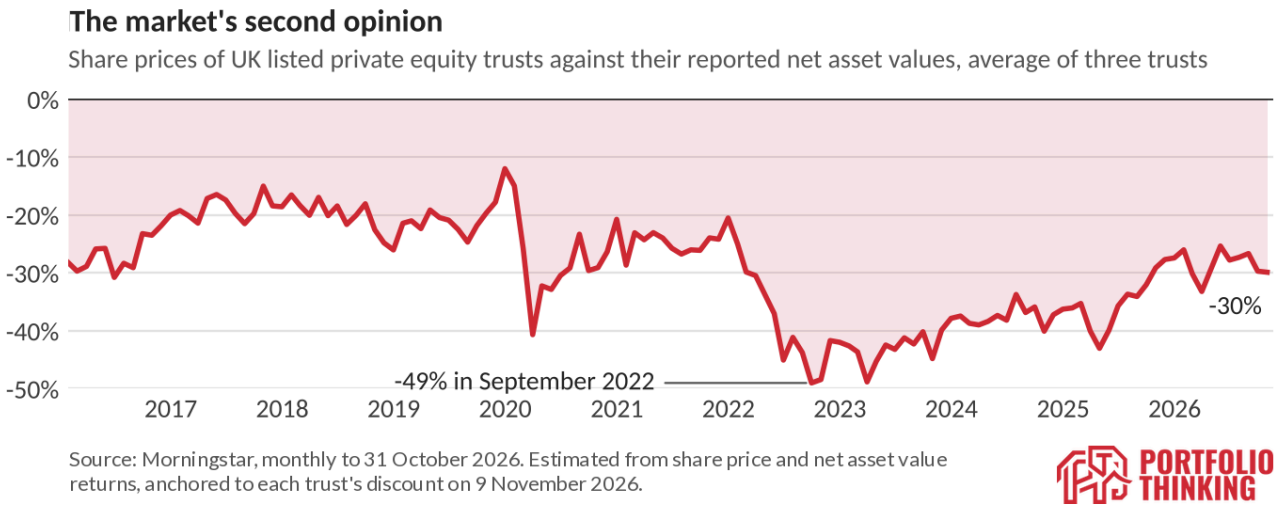
Those insurers have become some of the largest buyers of private credit, sometimes from companies connected to them. Apollo originated about 73% of the invested assets of Athene, its US annuity business, at the end of 2025.

Who sets the price?

When investing, the price you pay for an asset is a key determinant of the future return. In private markets, that valuation is reported by managers rather than set by the market. The FCA's 2025 review of private market valuations found few firms able to demonstrate clearly that valuation was independent of the managers whose fees depend on it.

The listed market offers a second opinion. UK listed private equity trusts trade at an average of about 30% below their reported net asset values (figure 3), suggestive of some scepticism about those reported values. Investors in semiliquid funds are not given the opportunity to benefit from that discount but must buy and sell at net asset value.

FIGURE 3



Private markets reward patience, but they cannot manufacture liquidity. The time to mind the gate is before we walk through it.

What investors get wrong, and what to do instead

It is tempting to judge private assets by their smooth past returns and to treat quarterly dealing as a promise of access. A better habit is to judge them by the return they can reasonably be expected to deliver after all costs, and to plan as though withdrawals may be limited when they are most wanted.

Three ideas for portfolios

General ideas for advisers to consider against each client's objectives and circumstances; not personal recommendations.

1

Know every layer of cost. Private asset funds can carry management and performance fees, the costs of buying, financing and running the underlying assets, and platform or wrapper charges, and some of these are taken inside the fund rather than shown in its headline charge. Ask for all of them, and for how they would affect returns in good years and bad. Invest only where the expected return after every charge is more attractive than that of an equivalent public market fund.

2

Size for the gate. Treat private assets as money that may be out of reach for several years, and hold enough in liquid assets to meet withdrawals, rebalancing and unexpected needs without relying on a fund's quarterly dealing.

3

Consider the listed route alongside the semiliquid one. Private equity investment trusts have no gate and publish a market price, which currently sits at a discount to their reported values. That price can be volatile, and discounts can widen as well as narrow.

GEOPOLITICS

Built for Rougher Roads

07

After a decade that rewarded portfolios tuned for a single market environment, today's uncertainty calls for portfolios built to cope with many.

KEY TAKEAWAYS

1

Despite a decade of political and economic shocks, shares in developed markets returned about 13% a year in sterling, rewarding those who stayed invested.

2

That success encouraged portfolios tuned for a single future, one that relied on government bonds rising when shares fell. Since inflation returned in 2022, gilts and shares have tended to move together.

3

The answer is not to try to 'time' markets but to build more robust portfolios: stress tested, made from high quality components, and owned by clients prepared for a steadier journey.

In our view, the best response to the current environment is not to predict the next shock, but to build portfolios that can cope with a range of possible futures. A portfolio optimised for a single outcome is like a Formula One car that is built to go very quickly around a smooth and predictable track but is ill suited to a country road. For that journey we are better off in an SUV, slower in a straight line but far more robust when the surface is uneven and the conditions uncertain.

A decade of surprises

We have experienced a decade of extraordinary and often surprising change: the Brexit vote and Donald Trump's first election victory, the rise of populism at both ends of the political spectrum, a pandemic, war in Europe and unpredictable trade conditions. This year brought an attack on Iran, the closure of the Strait of Hormuz and, most recently, a change in control of the US Congress at the midterm elections.

Rewarded for staying invested

Over the same decade, stock markets have made solid progress. In sterling, £100 invested in shares of developed markets in May 2016 would have grown to about £372 by the end of October. Each time markets stumbled, investors who held their nerve, or added to their portfolios, were swiftly rewarded: the losses of the pandemic were recovered within five months of the low, and those of last year's tariff shock within three. By contrast, as figure 1 shows, an investor who sold after each fall of 10% or more, and reinvested only once shares had regained their previous high, would have ended with about £213.

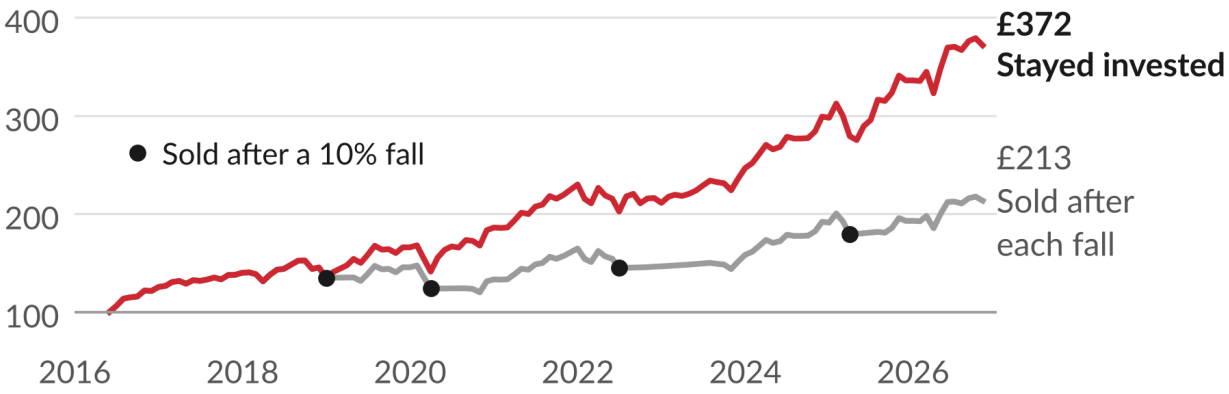
Consequently, shares now make up a much larger part of investors' wealth. US households hold close to half of their financial assets in shares, the highest proportion in Federal Reserve data that go back to 1945.

We are often reminded that it is time in the market, not timing the market, that matters. This reflects both the power of good businesses to grow over time and our tendency to buy and sell at the wrong moments. Morningstar's Mind the Gap study estimates that over the ten years to 2025 the average dollar invested in US funds earned 1.2 percentage points a year less than the funds themselves, because of the timing of investors' purchases and sales. Frequent trading also adds costs and tax.

FIGURE 1

Staying invested beat selling after each fall

Growth of £100 in developed market shares, in sterling, May 2016 to October 2026



Source: Morningstar, monthly total returns in sterling of funds tracking developed market shares and sterling cash, net of fees. The seller moves to cash at the first month end 10% or more below the previous high and reinvests once shares regain it. Ignores tax and dealing costs.

Tuned for one track

This long run of success encouraged many investment managers to optimise their portfolios, tracking more closely the indices that led the market and making full use of their risk budgets. That approach worked well while the track was smooth, but it relied on government bonds rising when shares fell, rapid recoveries and steadily rising profits. The first of these failed in 2022, when inflation pushed interest rates and bond yields higher and gilts fell alongside shares. Importantly, government bonds tend to protect against market and economic contractions rather than inflation.

Protecting against a rougher road ahead

Some prominent investors, such as Ray Dalio, argue that the world order established after 1945 has broken down. Although this may make for fascinating (and sometimes frightening) conversation around the dinner table, it has a deeper relevance for investors.

A new geopolitical environment could disrupt the steady progress we have enjoyed for most of our investing lives. We caught a glimpse of it after the pandemic, when companies rushed to shorten supply chains and bring operations closer to home. Such resilience comes at a cost and may mean slower growth and thinner profit margins, while greater spending on defence could lead to higher taxes.

How do we prepare for this without trying to time the markets? In our view, the answer is to build more robust portfolios.

Test the vehicle before the journey

To build an SUV portfolio, we need to consider returns across a range of environments, and the best way to do this is to stress test candidate portfolios against a variety of positive and negative events, so that we find the potholes before the portfolio does. Figure 2 shows why.

In the five shocks of the past decade, no single asset protected a portfolio every time: gilts rose during the pandemic but fell by a quarter in the inflation shock of 2022, and gold rose in four of the shocks but fell by a tenth in March this year.

FIGURE 2

No asset protected in every shock

Total return in sterling during five shocks of the past decade, %

	Brexit vote 2016	Pandemic 2020	Inflation shock 2022	Tariff shock 2025	Iran war 2026
Developed market shares	+6	−16	−8	−8	−6
UK shares	0	−24	−7	−3	−7
Gilts	+5	+3	−25	+1	−4
Index-linked gilts	+10	+1	−33	−2	−3
Gold	+19	+8	+11	+10	−10
Cash	0	0	+1	+1	0

Source: Morningstar, monthly total returns in sterling of funds tracking each asset class, net of fees; cash is a sterling money market fund. Months covered: June 2016; February to March 2020; January to September 2022; March to April 2025; March 2026.

Testing candidate portfolios against a range of historical and possible scenarios (we use more than forty) exposes vulnerabilities that may not be obvious from a portfolio's exposures alone, because it reveals interactions and fault lines that matter more in some scenarios than in others. Through an iterative approach, we can then reduce these risks, or accept those that are both unlikely and of limited impact.

Better components

Next, we need components of the highest quality, since poorly made parts weaken a vehicle however well it is assembled. An SUV also needs differently engineered parts from a Formula One car, so we may need more flexible mandates and potentially a portfolio that looks less like the index. That requires deep research, and a way to compare expected returns and risks on a consistent basis, which is why a comprehensive set of capital market assumptions, anchored to today's prices, should sit at the heart of your approach.

Preparing the passengers

Finally, we must prepare ourselves and our clients for the journey. A passenger used to travelling rapidly around a smooth and predictable track will find an SUV on a country road uncomfortable, and the pace slower than they are used to. However, for most investors the real risk is not a slower journey but failing to reach their destination at all. If, as seems possible, we are entering a more difficult environment, reaching our goals will matter more than the pace at which we set off.

> **We cannot choose the road ahead, but we can choose the vehicle.**

What investors get wrong, and what to do instead

It is tempting to judge a portfolio by how quickly it travelled over the past decade and to change course whenever the headlines frighten us. A better habit is to judge it by how it would cope with the range of roads that may lie ahead, and to agree with clients in advance what will happen when markets fall.

Three ideas for portfolios

General ideas for advisers to consider against each client's objectives and circumstances; not personal recommendations.

1

Stress test before you build. Run your portfolios through a range of past and plausible shocks, including growth, inflation and currency shocks, and decide which vulnerabilities to reduce and which to accept because they are unlikely or of limited impact.

2

Diversify the protection, not just the assets. No asset protected a portfolio in every shock of the past decade. Consider combining government bonds, which have tended to help in slowdowns, with exposures that have behaved differently in other shocks, such as alternatives, sized so that no single one dominates. These can be volatile in their own right.

3

Set expectations before the road gets rough. Explain to clients that a robust portfolio may lag the index when markets are strong, and agree in advance how and when it will be rebalanced.

Important information

ABOUT THIS OUTLOOK

Expected returns are from Portfolio Thinking's capital market assumptions as at 11 November 2026, in sterling after inflation, and include currency movements for overseas markets. They are estimates, not forecasts or guarantees, are before charges and tax, and are not a reliable indicator of future returns. Changes in exchange rates can cause the value of overseas investments to fall or rise. The value of investments and the income from them can fall as well as rise. Past performance is not a reliable indicator of future returns. The ideas for portfolios in each article are general ideas for advisers to consider against each client's objectives and circumstances; they are not personal recommendations. This is not a personal recommendation.

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DATA AND SOURCES BY ARTICLE

01 Prepare, Don't Predict. Market data as at 10 November 2026 unless stated otherwise. Strategist targets are as reported by Bloomberg, Reuters and TheStreet and are shown for illustration; they are not Portfolio Thinking's views. The market level in figure 1 is the index of US large company shares.

02 Signposts, Not Satnav. The ranges shown reflect simulated combinations of our assumptions and do not capture every possible outcome.

03 Artificially Inflated? Market data as at 29 and 30 October 2026.

04 Have Bonds Met Their Dr No? Market data as at 9 November 2026. Yields are not guaranteed returns and are before charges and tax.

05 The Best Things Come in Small Packages. Market data as at 31 October 2026 unless stated otherwise. Shares in smaller companies can be more volatile and harder to sell than those in larger companies, and changes in exchange rates can cause the value of overseas investments to fall or rise.

06 Mind the Gap. Market data as at 31 October 2026 unless stated otherwise; trust discounts as at 9 November 2026. Withdrawal requests are as reported by the funds and the press and are not amounts paid; funds are named for illustration only. Discounts in figure 3 are estimated from Morningstar share price and net asset value returns. The illustration of costs in figure 2 is hypothetical, uses US averages and ignores tax and dealing costs. Private assets are illiquid and difficult to value, withdrawals from semiliquid funds and Long Term Asset Funds may be limited or suspended, and investment trust discounts may widen.

07 Built for Rougher Roads. Market data as at 31 October 2026 unless stated otherwise. Returns are total returns in sterling of funds tracking each asset class, net of fees, and do not represent any portfolio. The illustration of selling after falls is hypothetical and ignores tax and dealing costs. Gold and overseas investments can be volatile, and changes in exchange rates can cause the value of overseas investments to fall or rise.

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From Prediction to Preparation

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