

# Mid-Quarter Update

## OVERVIEW

In the opening weeks of 2026, investors are understandably looking for signs of enduring themes for the year. “Broadening and volatility” may be fitting – market action has been defined by both so far – but only time will tell. Market broadening comes despite a host of potentially volatility-inducing catalysts to accompany the new year: Fed independence, military conflict, and wild currency swings, to name a few. Fortunately, many things are working in favor of the economy, chiefly continued corporate profit growth. So long as such growth is sustained, investors may continue to enjoy their equity exposure.

We often look at prior periods of market history for guiding context. This moment reminds us of the 2023 and 2024 markets. 2023 was defined by extreme narrowness and 2024 gave way to broadening participation as the market continued to advance. We view broadening as healthy for supporting equity returns, particularly with several strong years now in the rear-view mirror. But broadening does not mean non-volatile. Indeed, this is a mid-term election year in the US, historically a predictor of elevated market volatility.

## MARKETS CAN BROADEN FOR SEVERAL REASONS:

1. Leaders catch down via a collapse in their valuations.
2. Laggards catch up through valuation expansion.
3. Broadening earnings growth pumps up laggards’ returns without valuation change.

The first outcome seems less likely today given the fundamental soundness of leading companies. But we are attentive to developments such as declining free cash flow among leaders like the Magnificent 7. AI infrastructure investment is demanding a growing share of the cash generated by even these elite cash compounders. This, and shifting sentiment around continued infrastructure spending has widened performance dispersion within the group to start the year.

The second option may be more likely as valuation levels for laggards (e.g. everything but the Magnificent 7 in the S&P 500, the S&P 493) are lower than the average Magnificent 7 constituent valuation. But this is a relative consideration, and valuations across much of the equity market are elevated versus history, potentially limiting the scope of further absolute valuation expansion.

Perhaps the most likely outcome is a broadening of *earnings* growth driving laggard company returns. This aligns with the ongoing corporate profit growth mentioned earlier and the strength in the earnings cycle now underway. Moreover, if the current AI investment cycle is to pay off, the scale of the payoff should be large relative to already-sizeable capital outlays. This is another way of saying the payoff should involve broad economic value creation.

## WE CANNOT PREDICT WHAT 2026 WILL BRING FOR INVESTORS, BUT WE CAN MAKE A FEW OBSERVATIONS TO GUIDE FUTURE POSITIONING:

1. Trailing large cap equity returns are quite high and equity returns tend to mean revert. It may be more productive to identify areas of the market that have been overlooked and where expectations are low rather than maintain or continue to allocate to what has already done well.
2. As a result of high past returns, many investors have come closer to meeting their investment goals. Protecting progress may become a more important consideration if lower future returns or more volatile returns are probable.
3. High trailing returns have been driven partly by narrow market leadership, leaving many investors with more concentrated positioning than in the past. Concentration can be a wonderful *wealth generation* tool, but it often stands at odds with long-term *wealth preservation*.

Dividend growth as an active investment discipline offers a unique set of characteristics to address these positioning challenges. These characteristics include the following observations:

- An overwhelming contribution to equity returns over the last 15 years has come from price appreciation rather than dividend return. A century of market history suggests these sources of return should be more balanced. Dividends may be an overlooked potential contributor to future total equity return. These low expectations may represent an opportunity for future portfolio positioning.
- *Active* dividend growth portfolio management can emphasize risk management through diversification and exposure to lower-volatility, cash-producing companies. These features can be a powerful complement to existing concentrated or market-like exposure.
- Dividend growth companies represent a diverse cross-section of public equity markets. This diversification can be highly complementary to the concentrated thematic exposure investors may find in their portfolios currently.

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## CLOSING THOUGHTS

Outside of these matters, we find many investors are attracted to the dividend growth discipline by the utility of income generation, the potential of this income to grow ahead of inflation over time, and the logic of matching cash generation from investments with the cash needs of important goals.

Further, the potential for lower or more volatile market returns ahead may justify strategies to preserve investor progress and provide increased certainty through a discrete cash flow element of investment positioning.

As optimistic equity investors, we at Bahl & Gaynor remain focused on identifying businesses with solid underlying growth prospects supporting expanding cash generation. Such cash generation can drive future dividend payouts and provide financial flexibility across the range of potential economic and market paths outlined above. This extends to the disciplined execution of our active, risk-aware dividend growth strategies amid a broadening but volatile backdrop. We thank our clients for continuing to entrust us with their capital and look forward to serving both current and future clients.

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