



# Artificial Intelligence Powered Diversification - SMID Opportunities



## From the Desk of the Quantitative Equity Team

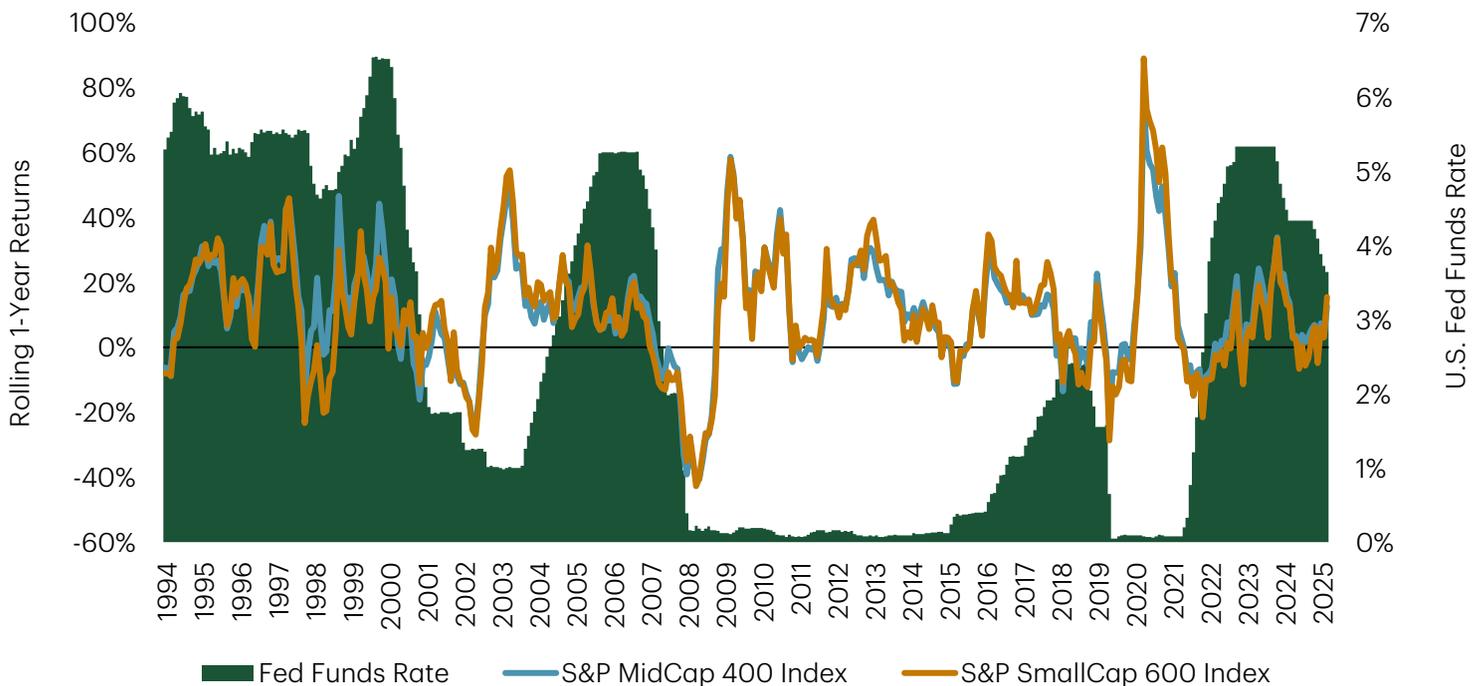
By Michael Formuziewich, CFA and Julien Palardy, CFA edited by Lisa Bissnauth

*Recent market performance has been dominated by a small group of mega-cap artificial intelligence-driven stocks, increasing concentration risks. As rate cuts begin to take effect, combining small- and mid-capitalization companies (SMID), supported by the advanced quantitative platform at TD Asset Management Inc. (TDAM, we, our), can offer a disciplined approach to diversification and help navigate an increasingly concentrated equity market.*

### Artificial Intelligence (AI) Driven Benefits Favour SMID and Highly Scalable Companies

Firms in the middle of the market can face more complex adjustment challenges than those at the top. The U.S. Federal Reserve (the "Fed") has been cutting rates since 2024 and is expected to continue in 2026. As the effects of rate cuts work their way through the economy—typically with a lag of several months—conditions generally become more supportive for the more economically sensitive small- and mid-cap stocks. As shown in **Chart 1** below, SMID returns experienced an upward inflection following the rate-cutting cycles in 2000 to 2003, 2007 to 2008 and 2019 to 2020, with gains emerging almost immediately after the end of each cycle. As a result, we would expect to see SMID returns accelerate once the U.S. approaches the end of the current rate-cutting cycle.

**Chart 1: Fed Funds Rate and SMID Rolling 1-year Returns**



Source: TD Asset Management Inc., Bloomberg L.P. As of January 31, 2026.

## The TD Quantitative Advantage

The Quantitative Equities Team at TDAM (the "Team") employs a broad and deep research framework. Rather than relying on a narrow set of inputs, the models begin with hundreds of factors, allowing the Team to capture a wide range of drivers across fundamentals, market behaviour, and company-specific information. In addition, TDAM uses both traditional linear alpha models and a recently introduced AI-based, non-linear alpha model. This AI model is designed to identify interactions between factors—for example, where certain factor relationships may be relevant for one subset of stocks but not another—allowing the model to adapt to different market environments and company characteristics within the SMID universe.

*The quantitative approach is style-agnostic, incorporating signals across growth, value, quality, momentum, and other factors. As a result, the models are not constrained by any single investment style and can instead respond to where the compelling opportunities emerge.*

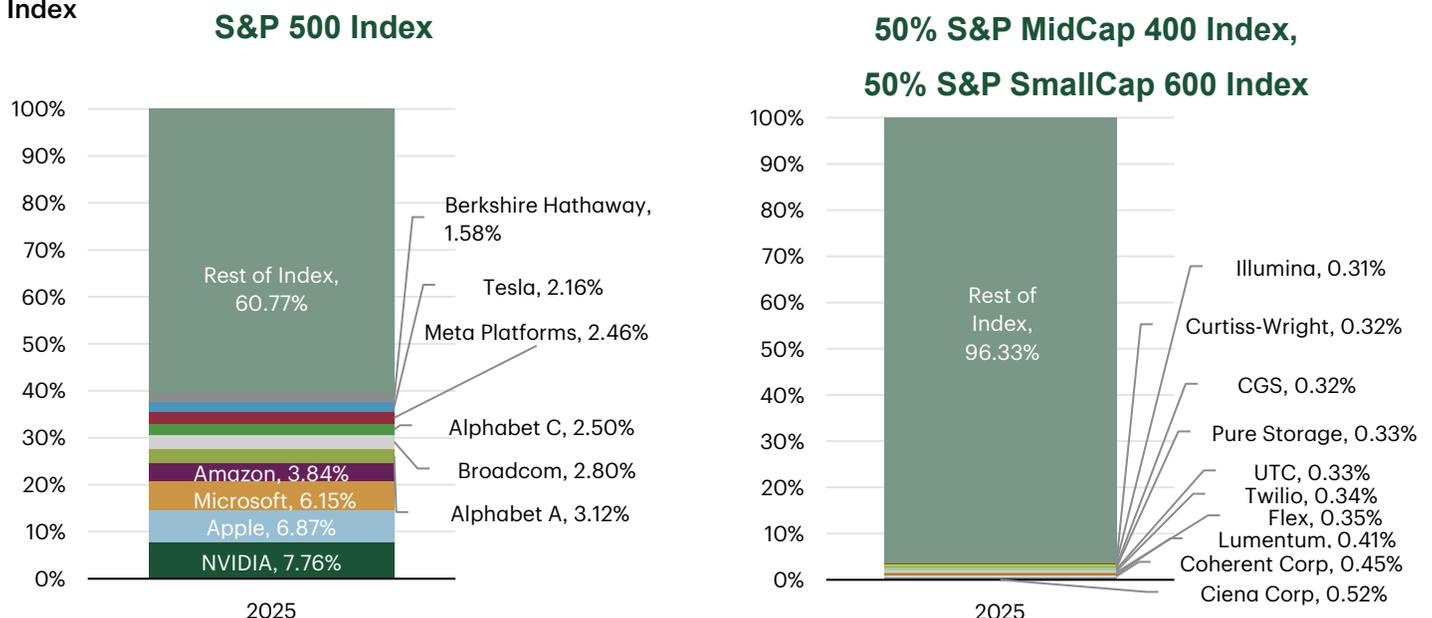
## Proprietary Natural Language Processing (NLP) Models for Earnings Analysis

These insights are translated into measurable factors that complement traditional financial data, expanding the information set available to the alpha models. Our quantitative process can quickly analyze thousands of earnings calls, converting unstructured insights into actionable factor signals. Our alpha models are designed to identify which factors are most relevant to stock returns. For example, the drivers of performance in small- and mid-cap stocks may differ from those in large-cap stocks, and the models dynamically adapt to these differences. This level of granularity is a potential advantage over more static approaches.

## Reducing Mega-Cap Concentration Risk with a Disciplined SMID Framework

From a risk-based quantitative perspective, concentration matters as much as returns. Within the large-cap universe, the Team highlights that a small number of mega-cap stocks now account for a disproportionate share of index volatility, increasing instability in large-cap benchmarks. In contrast, SMID universes, exhibit significantly lower stock-specific risk concentration, as seen in **Chart 2** below, a characteristic that quantitative models identify as increasingly valuable in today's market structure. With the S&P 500 Index representing approximately 80% of total U.S. market capitalization, allocation to the small- and mid-cap equities serve two key purposes: first, it can reduce the concentration risk inherent in large-cap portfolios; and second, it enhances diversification by adding exposure to companies whose return drivers differ from those of large- and mega-cap stocks. The style-agnostic TD Q U.S. Small-Mid-Cap Equity ETF (TQSM) - an award-winning<sup>1</sup>, quantitative strategy - can provide instant diversification and efficient access to both the small- and mid-cap segments of the U.S. equity market in a single fund.

**Chart 2: Concentration of S&P 500 Index versus 50% S&P MidCap 400 Index and 50% S&P SmallCap 600 Index**

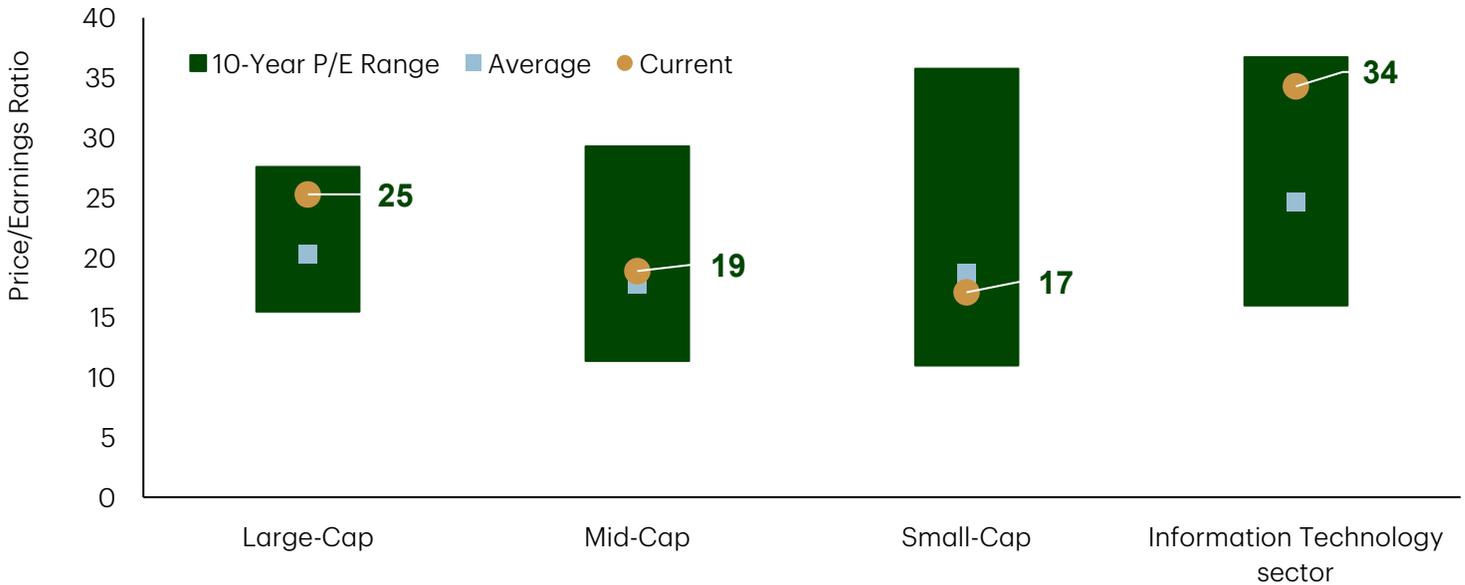


Source: TD Asset Management Inc., FactSet Research Systems Inc. As of December 31, 2025

## SMID Valuations Are Attractive, Especially Compared to Large Cap Stocks

Largely due to elevated valuations in the Information Technology sector, the overall large-cap market is trading at approximately 25x earnings, which is near the top of its 10-year price-to-earnings (P/E) range and roughly 5 turns above its long-term average. By contrast, small- and mid-cap stocks are trading at more moderate valuations of approximately 17x and 19x earnings, respectively. In our view, these more reasonable valuations, combined with economic conditions can become increasingly supportive as the Fed continues to lower rates, create an attractive backdrop for small- and mid-cap equities.

**Chart 3: 10-year P/E Range by Capitalization**



Source: TD Asset Management Inc., FactSet Research Systems. As of December 31, 2025.

**In a market dominated by a handful of mega-cap stocks, SMID equities—accessed through a sophisticated quantitative framework— can offer meaningful diversification, more compelling valuations, and renewed upside potential as rate cuts begin to benefit the broader economy.**

**For further information,  
please contact your investment professional.**



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<sup>1</sup> The TD Q U.S. Small-Mid-Cap Equity ETF (TQSM) was awarded the FundGrade A+™ Award in the U.S. Small/Mid Cap Equity category for the period ending December 31, 2015 out of a total of 47 funds. The FundGrade A+™ Awards is used with permission from Fundata Canada Inc., all rights reserved. The annual FundGrade A+™ Awards are presented by Fundata Canada Inc. to recognize the "best of the best" among Canadian investment funds. The FundGrade A+ calculation is supplemental to the monthly FundGrade™ ratings and is calculated at the end of each calendar year. The FundGrade rating system evaluates funds based on their risk-adjusted performance, measured by Sharpe Ratio, Sortino Ratio, and Information Ratio. The score for each ratio is calculated individually, covering all time periods from 2 to 10 years. The scores are then weighted equally in calculating a monthly FundGrade rating, which is subject to change every month. Funds with the highest 10% receive a grade of A, the next 20% a grade of B, the middle 40% a grade of C, the next 20% a grade of D, and the lowest 10% a grade of E. Eligible funds must have received a FundGrade rating every month in the previous year to be considered for the annual FundGrade A+ Awards. The FundGrade A+ Award uses a GPA-style calculation, where each monthly FundGrade rating from "A" to "E" receives a score from 4 to 0, respectively. A fund's average score for the year determines its GPA. Any fund with a GPA of 3.5 or greater is awarded a FundGrade A+ Award. For more information, see [www.FundGradeAwards.com](http://www.FundGradeAwards.com).

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