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Diversification can help navigate market volatility

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Investors have been kept in a state of heightened anxiety in recent weeks by a combination of trade tensions, geopolitical shifts, and economic uncertainty. But in such times, investors should not lose sight of timeless investment principles. The latest UBS-sponsored Global Investment Returns Yearbook, which charts market performance over the past 125 years, underlines the merits of diversification, especially in periods of volatility.

Investors have remained on high alert as relations between the US and its main trading partners continue to deteriorate. On Thursday President Donald Trump threatened to impose a 200% tariff on wines and other alcoholic products from Europe, if the European Union maintains a planned levy on American whiskey. This was just the latest in a series of tit-for-tat exchanges that have revived market fears of stagflation—a combination of faster inflation and slower growth.

Such worries have boosted volatility. The VIX index of implied US stock volatility, a popular gauge of investor anxiety, climbed to its highest level of the year earlier this week, and at 24 on Thursday is comfortably above the multi-decade average of 20. Fast-moving geopolitical developments and uncertainty over the likely pace of Federal Reserve rate cuts have also been keeping investors on edge.

Staying up to date with such developments is important. But it is also crucial to keep sight of longer-term investing principles that can boost risk-adjusted rates of return—such as diversification. This was one of the key messages from our recent update to the Global Investment Returns Yearbook—a survey of market performance of 125 years by Professor Paul Marsh and Dr. Mike Staunton of London Business School and Professor Elroy Dimson of Cambridge University:

Global equity diversification can mitigate concentration risks. Historical data show that for US dollar-based investors, risk decreases as the number of countries in a stock portfolio increases. The standard deviation of US dollar real returns

for a typical single-country investment is 29.1%, which falls to 18.6% for an equally weighted 21-country portfolio and 17.2% for a capitalization-weighted 21-country world index.

Multi-asset diversification can provide portfolio resilience. While returns correlations have been on the rise lately (that is, different asset classes have been performing in increasingly similar ways), multi-asset diversification remains an important principle. Over the long term, the 60:40 US blended portfolio of US stocks and Treasury bonds has historically delivered an annualized real return of 5.1% in local currency terms (versus 6.6% for stocks and 1.6% for bonds), with lower volatility at 13.4% compared to stocks alone at 19.8% and 10.7% for bonds.

Extending one's toolkit to include gold into a portfolio can help during periods of increased uncertainties and may provide a hedge against inflation, as gold has shown a positive correlation of 0.34 with inflation since 1972. Incorporating alternative investments such as private equity, private debt, private infrastructure, or private real estate can help diversify sources of return and potentially enhance portfolio growth, subject to careful management of alternative assets' unique risks such as illiquidity.

Cross-asset diversification can alleviate crises' impacts. While stock and country diversification may be less effective during immediate crisis periods, cross-asset correlation can be more impactful. During crises, the correlation between stocks and bonds tends to be negative due to a flight to perceived safe havens like government bonds. This makes highly rated government debt a valuable diversifier that may enhance portfolio diversification when it's most needed.

So, we recommend investors embrace diversification and stay invested despite ongoing volatility. We see continued positive potential returns in the US, AI, and power-and-resources-linked equities into year-end but see scope for investors to hedge equity exposures through use of tools like structured strategies with capital preservation features or structured solutions that generate income from higher volatility while systematically buying stocks on dips.

We still see select opportunities outside the US. In Europe, our "Six Ways to Invest in Europe" portfolio aims to take advantage of six drivers: 1) a cyclical economic recovery ahead in Europe; 2) post-election beneficiaries in Germany; 3) rising security investments (defense and cyber); 4) rebuilding Ukraine and a recovery in Eastern Europe; 5) beneficiaries of lower energy costs in Europe; and 6) globally active European companies with limited global trade risks. In Asia, we like India and Taiwan equities.

Beyond geographical equity diversification, investors looking to navigate a tense geopolitical environment should ensure their portfolios are well-diversified with quality bonds, gold, and alternative investments.

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