Investment Insight
Why Portfolio Diversification Has Helped in 2025

Morningstar Investment Management LLC
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Amy C. Arnott, CFA, Morningstar.com

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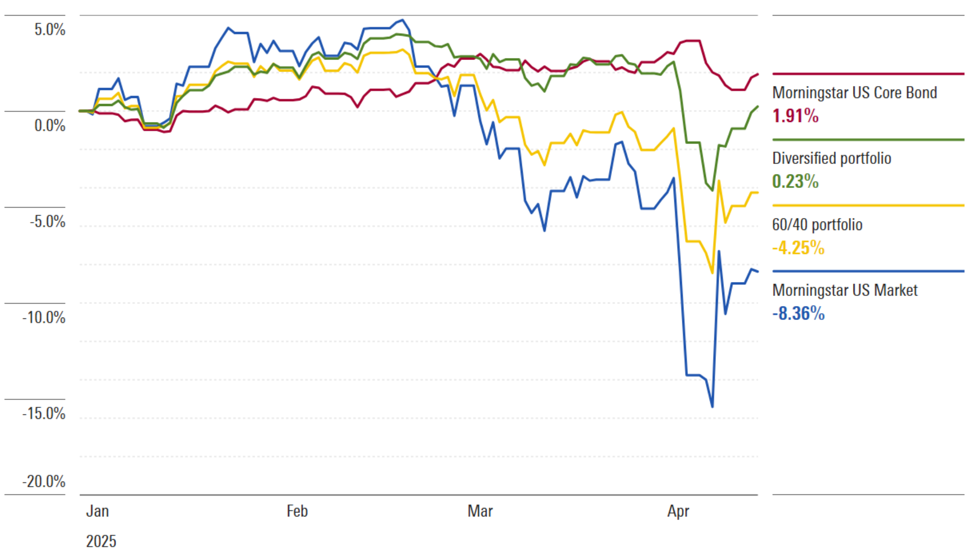
Key Takeaways:

- It hasn't been a panacea, but it has generally worked in investors' favor. Learn how a diversified investment strategy may work to help smooth volatility.

The recent bout of market turmoil has many investors on edge. Following President Donald Trump's tariff announcements in early April, the equity market suffered two of its biggest one-day losses since the global financial crisis and then staged a partial rebound the following day.

Market volatility has calmed down a bit now that most tariffs have been temporarily paused, but uncertainty about tariff policy and a potential economic recession remains well above average. The good news: Not every asset class has sold off by the same amount, and some asset classes are still in the black for the year to date. As a result, adding asset classes that don't move in tandem with US stocks has generally been helpful.

How Portfolio Diversification Has Paid Off in 2025



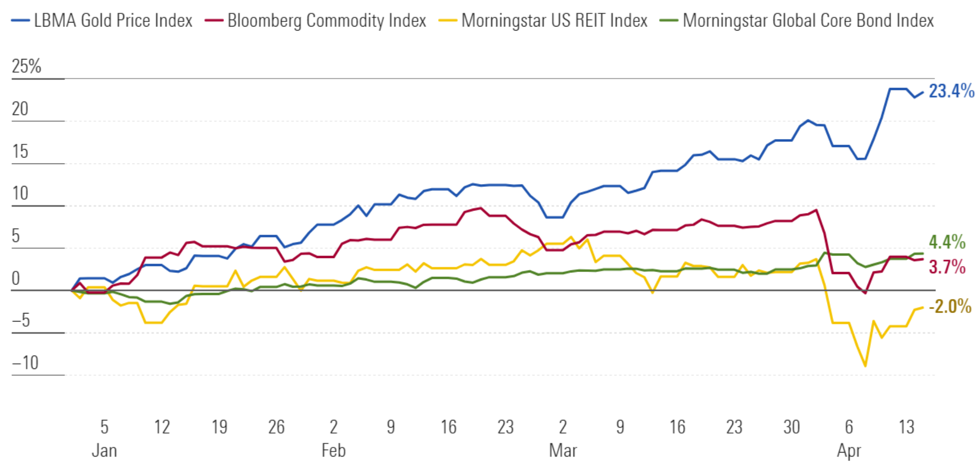
Source: Morningstar Direct. Data as of 4/15/2025.

At the highest level, bonds have generally held up well and served as a partial buffer against losses. The Morningstar US Core Bond index of investment-grade bonds has gained about 1.9% for the year to date through April 15, 2025.

Granted, bonds weren't uniformly a great place to be. There have been a few days when US Treasury yields have spiked while stocks have also sold off, indicating some investor uncertainty about the status of Treasuries as a guaranteed safe haven.

However, bond exposure has still been a net positive for the year to date. As a result, a basic 60/40 portfolio combining US stocks and investment-grade bonds has lost about half as much as an equity-only portfolio for the year to date through April 15.

Other Asset Classes With Relatively Strong Returns



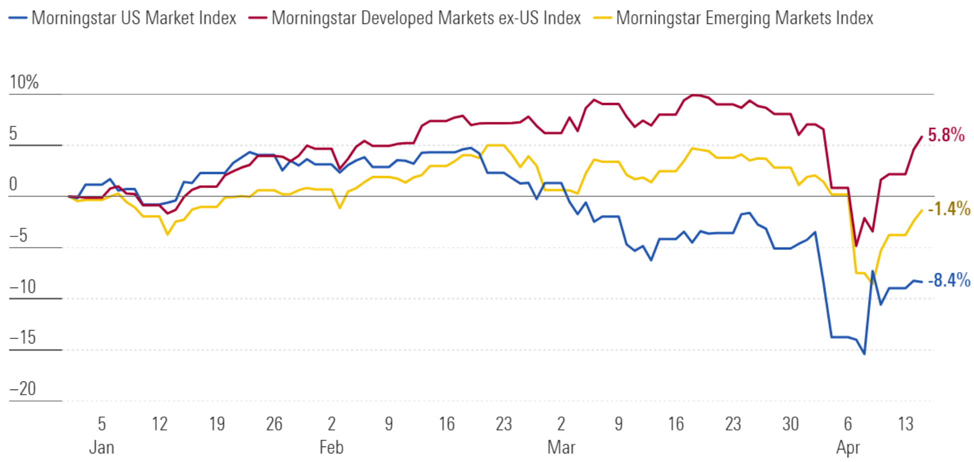
Source: Morningstar Direct. Data as of Apr. 15, 2025.

While having some bond exposure has been helpful, a broader approach to portfolio diversification has paid off more, at least so far in 2025.

In our recently published 2025 Diversification Landscape report, we examined a more diversified portfolio spanning 11 different asset classes. We allocated 20% of the portfolio to larger-cap domestic stocks; 10% each to developed- and emerging-markets stocks, Treasuries, US core bonds, global bonds, and high-yield bonds; and 5% each to US small-cap stocks, commodities, gold, and REITs.

As shown in the first chart above, this portfolio has held up significantly better than the plain-vanilla 60/40 portfolio, generating a slightly positive return for the year to date. This reflects stronger returns from certain asset classes such as gold, commodities, REITs, and global bonds.

U.S. versus Non-U.S. Stocks

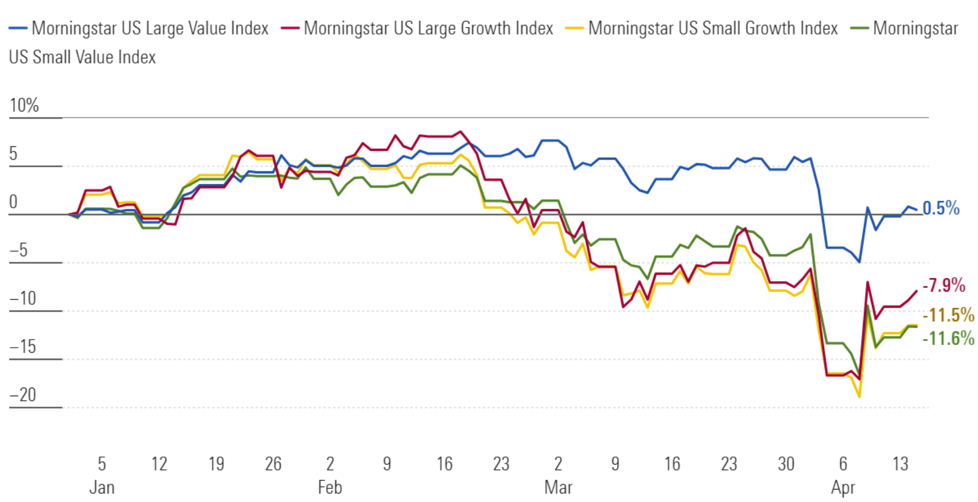


Source: Morningstar Direct. Data as of Apr. 15, 2025.

Stocks outside the US have also held up better than their domestic counterparts, particularly in developed markets such as Europe, the United Kingdom, and Japan. Heading into 2025, valuations on international stocks were significantly lower than those in the US, which gave them more room to rise as investors started worrying about the negative impact of tariffs on economic growth in the US. Currency movements also provided a tailwind, as the US dollar has depreciated against nearly every major foreign currency except the Canadian dollar so far this year.

The dollar's weakness reflects a lack of investor confidence about US economic growth and growing uncertainty about the dollar's previously unquestioned status as the dominant global reserve currency. As other currencies have gained strength versus the dollar, this shift has boosted returns for international-stock indexes when translated back into dollar terms.

Performance by Investment Style

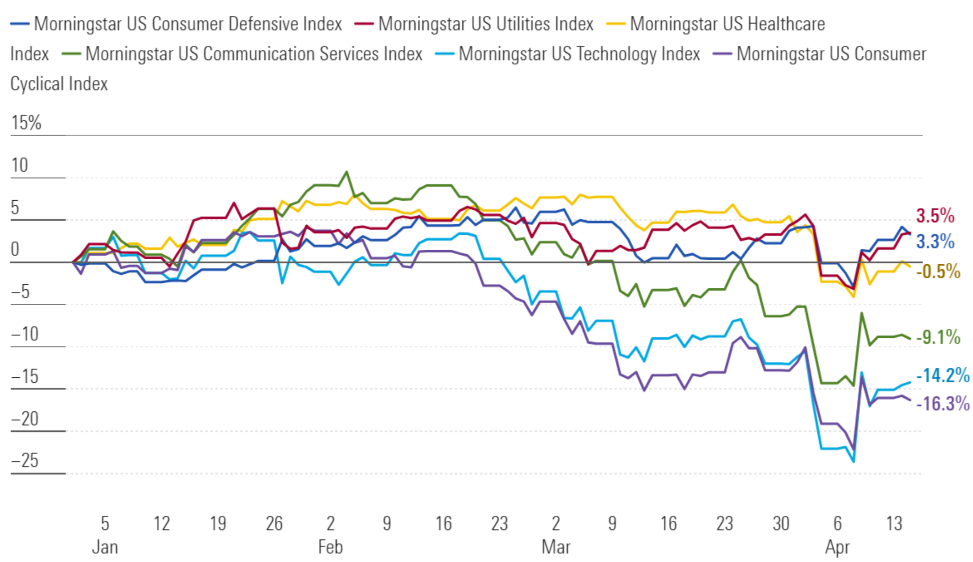


Source: Morningstar Direct. Data as of Apr. 15, 2025.

From a style perspective, value stocks have held up better than growth-oriented issues, partly because of profit-taking in stocks with elevated valuations earlier in the year. But just as dramatic has been the divergence between large and small.

As fears about a potential recession have grown, small-cap stocks have fallen behind by a wide margin. Larger companies tend to have more stable earnings, more diversified business operations, and the financial wherewithal to sustain their operations even during recessions. Smaller companies, on the other hand, may depend heavily on a single line of business and are more vulnerable to economic weakness.

Performance by Sector

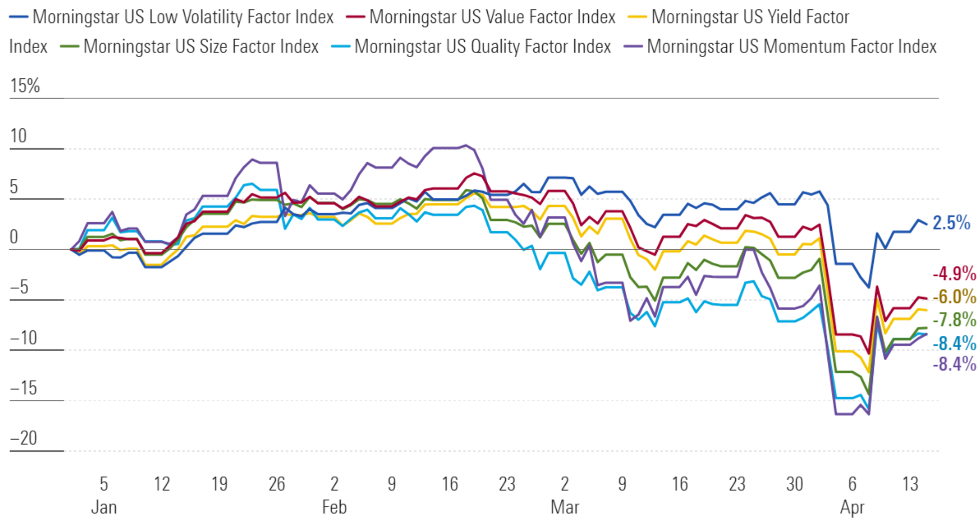


Source: Morningstar Direct. Data as of Apr. 15, 2025.

Returns for different sectors have also spanned a wide range so far this year. Consumer defensive stocks, which include well-known consumer brands such as Procter & Gamble PG, Kraft Heinz KHC, and Kimberly-Clark KMB, have held up much better than most other sectors. These types of stocks—along with other sectors such as healthcare and utilities—have historically been some of the most resilient performers during periods of economic weakness. Consumers can't easily cut back on household basics like canned goods and paper towels even if they're feeling the effects of a weaker economy.

On the negative side, technology stocks and consumer cyclicals have been some of the hardest-hit during the most recent downturn. This reflects their exposure to tariffs on imported components that they need to use to manufacture their products, as well as the fact that they would likely suffer during an economic downturn.

Performance by Equity Factor



Source: Morningstar Direct. Data as of Apr. 15, 2025.

Investment factors are another way of examining the drivers of equity market returns. A factor is a way of describing the underlying characteristics of a stock that goes beyond traditional metrics such as sector, market cap, and value/growth, although some investment factors also overlap with traditional style-based metrics.

The low volatility factor, which focuses on stocks that have historically had a smaller range of returns, typically fares well in weaker markets, as investors take refuge in less-volatile stocks, such as Microsoft MSFT, Berkshire Hathaway BRK.B, and Johnson & Johnson JNJ.

Value and yield have also been relatively resilient, but the momentum factor suffered the worst losses for the year-to-date period.

Counterintuitively, the quality factor has not held up particularly well. That's mainly because of weakness in some larger holdings such as Nvidia NVDA, Alphabet GOOGL, and Arista Networks ANET. Overall, the relatively wide range of returns across investment factors underscores the importance of broad portfolio diversification—in other words, not loading up on stocks that are all exposed to the same factor.

Conclusion

The market has been unusually chaotic over the past few weeks, making it even more difficult than usual to predict how performance might unfold in the future. It's also tough to predict how asset-class correlations might shift going forward. Even so, asset-class performance so far in 2025 generally underscores the value of holding a broadly diversified portfolio.

Our recently published 2025 Diversification Landscape report examines portfolio diversification from many other perspectives, including a broad range of asset classes, options-based portfolio strategies, leveraged and inverse investment products, and portfolios focusing on private capital markets. We also take a deep dive into portfolio diversification over longer periods and in different types of market environments, such as periods of rising interest rates, above-average inflation, and economic recessions.

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For More Information

Phone: +1 800 866-1749
Email: wealth.us@morningstar.com
Online: www.mp.morningstar.com

MORNINGSTAR Wealth

22 West Washington Street
Chicago, IL 60602 USA