Building portfolio resilience: why today's approach needs to be different

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Structural changes in financial markets mean we need a different mix of asset classes to deliver dependable returns.

For decades, diversification strategies focused on the two traditional asset classes: stocks and bonds. The use of these assets evolved significantly, but they remained core building blocks. Two critical factors had to remain in place, however, for this strategy to keep working: a low correlation between the two asset classes and limited volatility for bonds, given the reliance on them as a source of stability. Among other structural market changes, these two factors are no longer in place.

As a result, an era of simplistic portfolio construction – with its reliance upon asset class assumptions that no longer hold true – is over. Creating resilience within portfolios requires a new approach and a new asset mix.

Asset allocation: what worked in the past, and why it's not working now

In the "safety first" period after World War II, investors considered capital preservation their top priority, and portfolios were weighted heavily toward fixed income.

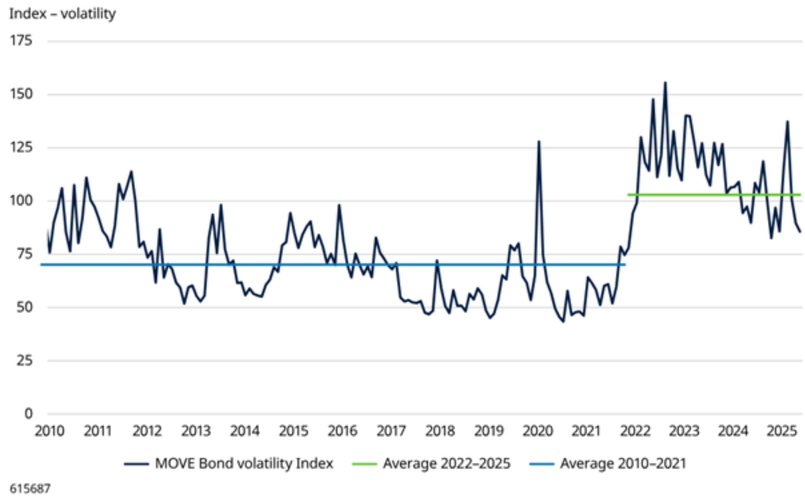
As the long-term growth that equities could deliver became increasingly apparent in subsequent decades, the 60/40 approach to diversification emerged. Even as investors pursued the higher long-term gains stocks offered with a 60% allocation, keeping portfolios 40% invested in fixed income proved a reliable means to achieve stability. Some investors even sought exposures beyond 100% limits of their portfolios by deploying leverage.

By the late 1980s, many large institutions began to add alternative investments, including private markets, to their allocations. By the early 2000s, the allocation to "alts" among large institutional investors often reached 15%-20%.

But for most individual investors, small institutional investors, and many defined contribution retirement plans, the 60/40 portfolio remained the trusted approach to diversification. Markets helped: from the mid-1990s to 2021, a low, often negative, correlation between stocks and bonds contributed to the effectiveness of the 60/40 approach.

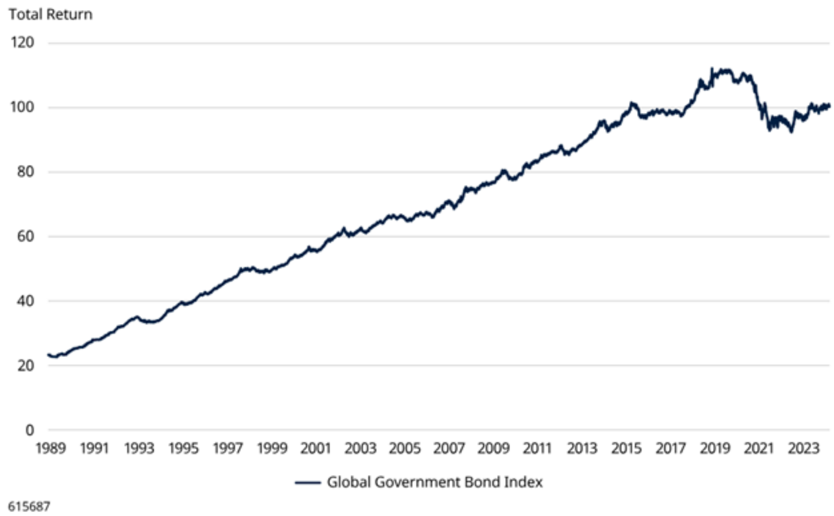
Recent years have confounded those expectations. Since 2022, global bond markets have been much more volatile (Chart 1) and that has made bonds a less dependable source of returns (Chart 2).

Since 2022, bonds have exhibited much higher levels of volatility



Source: Bloomberg, Robert Shiller, Schroders, LSEG Datastream. As at 11 July 2025. ***Past performance is not a guide to future results.***

With recent volatility, bonds struggled to deliver reliable returns



Source: Global Government Bond Index. Bloomberg, Robert Shiller, Schroders, LSEG Datastream. 31 December 1990 = 100. As at 11 July 2025. ***Past performance is not a guide to future results.***

The correlation between bond and equity returns rose significantly in the aftermath of the Covid-19 pandemic from a combination of factors that adversely affected both markets, including a spike in inflation driven by supply-chain challenges, soaring interest rates, a surge in commodity prices and geopolitical turmoil (Chart 3). The correlation has remained at elevated levels.

As a result of all this, the 60/40 portfolio experienced severely negative returns, as exemplified by a US-focused portfolio. With its exposure to the S&P 500 Index and US

Treasury bonds, the 60/40 portfolio was down nearly 18% in 2023, posting its worst year since 1937.[1]

Correlations between stocks and bonds have turned highly positive

Source: Robert Shiller, Schroders, LSEG Datastream. Equity returns are represented by the returns of the S&P 500 Index; bonds, by the 10-year US Treasury. As at 11 July 2025. ***Past performance is not a guide to future results.***

Recognising structural external changes…

To understand why the old assumptions no longer work, it's important to consider how the environment has changed and whether current circumstances will persist. We identify several long-term trends and resulting market conditions that we believe will extend into 2026 and beyond.

Increasing government debt

Government debt levels continue to soar, particularly in developed economies. Politicians have shown an unwillingness to address the underlying issues, creating uncertainty in bond markets which were previously considered creditworthy.

Aging populations

In most developed and several emerging markets, aging populations result in shrinking workforces and are likely to exacerbate government debt challenges.

Interest rates to remain higher

Even without the potentially inflationary US tariff proposals laid out by the Trump administration, several factors look set to keep inflation high. These include tight labour markets, lingering supply chain constraints, ongoing deglobalisation and the longer-term costs associated with decarbonisation. The period of near-zero interest rates is squarely behind us.

…and distilling what they mean for financial markets

The comparatively benign years that followed the financial crisis of 2008-2009, when equities soared amid a backdrop of near-zero interest rates and low inflation, are over.

Slower growth and persistent inflation raise concerns for both bond and equity markets and suggest consistently higher volatility. Along with this volatility, the correlation between stocks and bonds is likely to remain high.

In this changed scenario although bonds may be less reliable as diversifiers, the return of higher yields makes them potentially attractive sources of income.

Shifts in market composition are also a factor, and that means investors need to look to a broader range of assets to meet their needs. The universe of equities quoted on the world's major public stock markets continues to shrink. More companies are now raising finance via private market channels. Today private equity and debt form a combined $13 trillion market, up from less than $1 trillion two decades ago.

Within the sphere of public equities market composition has also changed. The post-financial crisis period saw the emergence of mega-cap US stocks as a dominating force in global indices. By the start of 2025, US equities comprised over 70% of the MSCI World index and much of this dominance was due to fewer than 10 stocks.

Finding a new portfolio approach for a different reality

These changed circumstances demand a new strategy for achieving portfolio resilience. In our view, that approach must rely on three foundational principles.

1. **Income: the role of bonds changes.**
   Bonds still have a vital portfolio role, but their purpose has altered. They can no longer be counted on for downside protection during volatile equity markets. Bonds should now be viewed primarily as an income-generating asset, alongside other income sources.

2. **Active investing is critical.**
   Pursuing the broad market exposure that passive strategies provide is no longer a sound approach. During periods of heightened uncertainty, the dispersion of returns within asset classes increases. Only active managers can differentiate between securities and sectors with promising return potential and those whose upside might be severely limited.

3. **Wider diversification across both public and private markets.**
   Incorporating alternative asset classes across both public and private markets is essential. Equity and bond markets are often influenced by the same return drivers. By contrast, alternative investments—such as commodities, hedge funds, private equity and private debt—can provide valuable diversification because the drivers of their performance are so different. The same is true for credit alternatives beyond the traditional debt markets of government and corporate bonds. A broad spectrum of alternative and nontraditional asset classes can provide degrees of diversification that are not possible with an exclusive focus on traditional investments.

Income: the role of bonds changes

While bonds have historically functioned as diversifiers within portfolios we now see – for the reasons set out above – a return to their primary function as income generators.

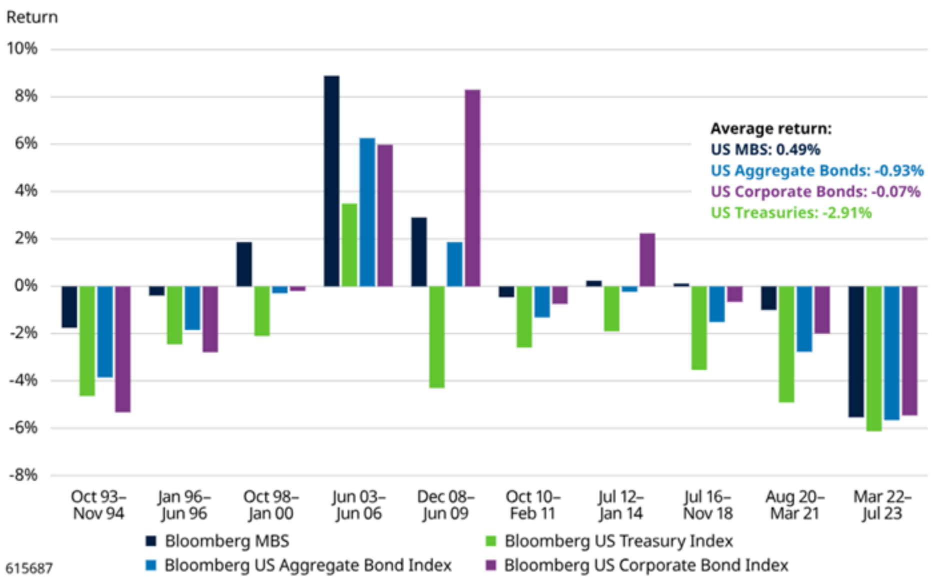
Even in that capacity, however, they require careful selection and management. Yields may be high today in comparison to much of the period following the financial crisis, but are they high enough to compensate for bonds' volatility? In many cases, not yet.

After a 30-year bond bull market, we may need to prepare for a protracted bond bear market. Within that, of course, some very attractive income opportunities will arise. We are seeing some of these today within short-duration bonds, for example.

With this bond volatility as a backdrop, income seekers need to turn to other assets too. **Private debt,** in its various forms, provides an alternative, stable, uncorrelated source of income. These loans often feature a floating-rate structure, meaning the income they deliver can change in line with a reference benchmark rate. As a result, private debt is typically much less sensitive to interest rate movements than fixed-rate public debt.

Mortgage-backed securities (MBS), too, have often fared well amid conditions that are adverse for other types of bonds, like rising-rate environments. MBS can be attractive in a rising-rate market because fewer consumers may decide to refinance as mortgage rates climb, and that stabilises the cash flow these securities deliver (see chart, below).

Mortgage-backed securities outperformed in most rising-rate environments



Source: Bloomberg, examining periods of rising rates that have occurred since 1993. ***Past performance is not a guide to future results.***

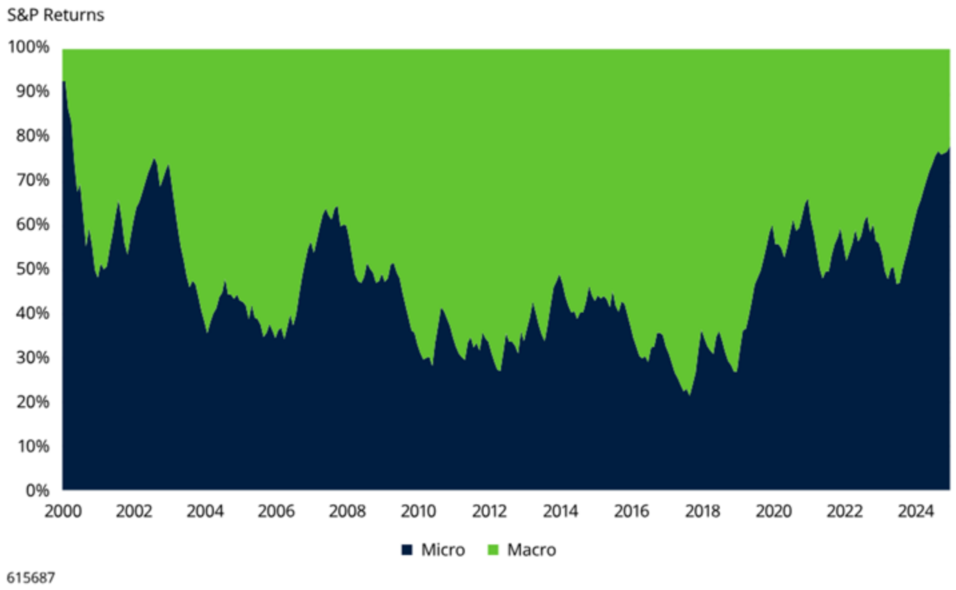
Active investing is critical

The changes that have occurred in the equity market have created a greater dispersion of returns, favouring active managers. Historically, the public equity markets have gone through cycles when the key drivers of returns shift between macro and micro factors.

In some markets, macroeconomic conditions – such as the economic growth rate, interest rates and the ease of access to capital – have a higher than usual impact on stock market performance. In such climates the "rising tide lifts all boats" phenomenon applies. Passive strategies that provide broad market exposure can do well in such conditions.

After the global economy emerged from the financial crisis of 2008-2009, for example, macro factors for many years (with a few notable single-year exceptions) had a considerable impact on equity returns, as many companies and sectors benefited from the global economic recovery (see chart below).

While micro factors are often the dominant influence on equity returns, the impact of macro factors has waxed and waned over time



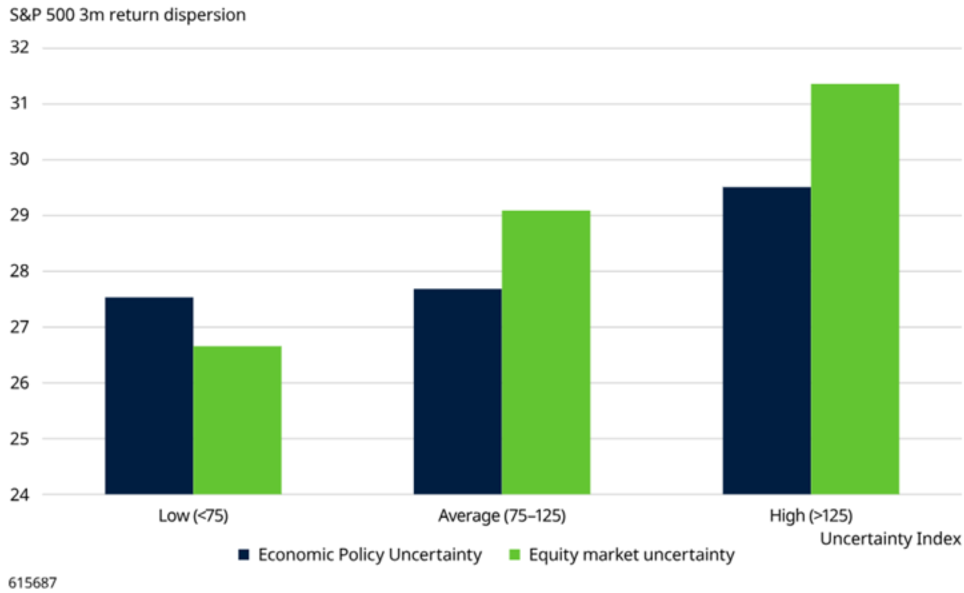
Source: Goldman Sachs, Schroders, LSEG Datastream, 11 July 2025. ***Past performance is not a guide to future results.***

Active managers who can invest more in the companies and sectors that excel in a particular macroeconomic climate can still deliver excess returns for investors during these periods.

At other times, micro factors – the circumstances of individual companies and particular sectors – have a much greater impact on overall stock market performance. At these times, active managers who focus on understanding those micro factors have even greater opportunities to outperform passive strategies.

When the fundamentals of companies and sectors are having a greater influence on equity returns than the broad macroeconomic factors, returns across the equity market can become much more dispersed. Perhaps not surprisingly, these periods often arise when there is greater uncertainty about the economy and the financial markets.

The dispersion of equity returns increases in periods of uncertainty



Source: Goldman Sachs, Schroders, LSEG Datastream, 11 July 2025. ***Past performance is not a guide to future results.***

Today there is considerable uncertainty. Heightened geopolitical tensions and a fragmentation of existing trade and political allegiances were already occurring even before President Trump's administration announced the raft of tariffs that rocked markets in April 2025.

While inflation has come down from the heights it reached after the pandemic, it remains at levels that have prevented central banks from loosening monetary policy via significant rate cuts. Central banks will likely have to maintain their balancing act between fostering growth and curbing inflation.

We see grounds for a continued heightening of return dispersion. These are conditions when active managers can excel and demonstrate, even more than usual, the value that they can bring to investors. Artificial intelligence (AI), which impacts every sector, is another outside factor that could amplify return dispersion. That's because some companies will harness and deploy AI in much more effective—and profitable—ways than others. Active managers can identify companies making the most of the capabilities AI breakthroughs can bring.

3. Wider diversification across both public and private markets

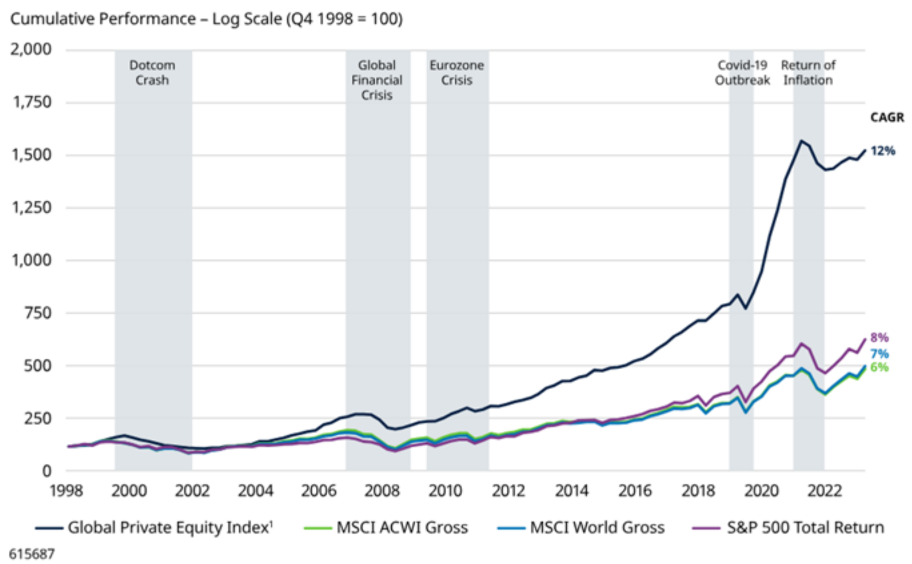
Alternative investments have done well in volatile, challenging markets. Exactly because they have such different return drivers and risk exposures, asset classes across the alternative investment spectrum have performed well in periods of heightened turbulence for public equity and debt markets.

Renewable infrastructure assets, like wind and solar farms, can continue to provide attractive income and total returns even during challenging periods for government debt, such as rising inflation and increasing interest rates. Many renewable energy projects operate under long-term, government-backed contracts or power purchase agreements (PPAs) that provide stable and predictable cash flows. These contracts also often include mechanisms for inflation protection, allowing returns to rise even when inflation is spiking.

Commodities like gold have provided valuable diversification in periods of greater uncertainty because at such times people want the assurance of owning tangible, hard assets. For that reason, commodities can provide a hedge when inflation is high and markets and currencies are volatile.

Private equity has demonstrated particular resilience during major crises over the past 25 years. In the turbulent markets that occurred over this period, which included the dot.com crash of 2001-2003, the Global Financial Crisis of 2008-2009 and the Covid-19 pandemic, private equity outperformed public equity (as measured by the MSCI All Country World Index) while also exhibiting significantly lower volatility.

Since 1998, the outperformance of private over public equities became twice as high during crisis periods

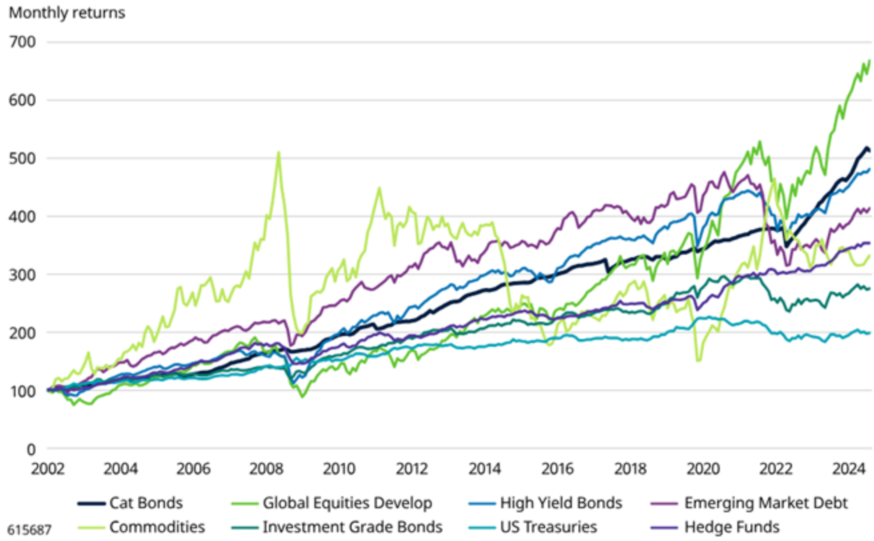


Source: MSCI (Burgiss), Schroders Capital. MSCI's Burgiss Global Private Equity Funds Index is a capitalization-weighted index consisting of Buyout, Venture Capital, and Growth funds. The performance figures are based on pooled quarterly time-weighted returns in $, net of all fees to Limited Partners. Simulated performance without crises assumes periods with market disruptions excluded. The compound annual growth rate (CAGR) is calculated over a shorter effective period to reflect the removal of these periods. ***Past performance is not a guide to future results.***

Private debt, as stated above in relation to bond alternatives, can provide stable, uncorrelated income.

Insurance-linked securities, such as catastrophe bonds, are a particularly compelling diversifier within the private debt universe. "Cat" bonds deliver a risk premium based on their exposure to insurable events like hurricanes, earthquakes or other natural disasters. The interest rate and credit cycles that have such a major influence on government debt and corporate bonds have little impact on catastrophe bonds. Instead, their returns depend primarily on the frequency of natural disasters and how insurance underwriters price the protection against these events. Cat bonds and other insurance-linked securities can thereby be a hedge against turbulence in traditional markets while providing an entirely differentiated source of income.

The diversification benefits of insurance-linked securities like catastrophe bonds persisted through periods of increased market volatility



Source: (LHS) LSEG Datastream 13 March 2025. (RHS) Schroders Capital, Bloomberg, monthly returns from 1 January 2002 to 31 January 2025 in USD. Cat bonds: Swiss Re Global Cat Bond TR Index, Global Equities Developed: MSCI World, High yield bonds: BofA Merrill Lynch Global High Yield Index, Emerging Markets Debt: JP Morgan EMBI+, Commodities: S&P GSCI, Investment grade bonds: Bloomberg US Corporate Bond Index, US Treasuries: BofA Merrill Lynch US Treasury, Hedge Funds: Credit Suisse Hedge Fund Index. ***Past performance is not a guide to future results.***

Hedge funds have long been valued for their flexibility and potential ability to generate returns across different market cycles. By employing a range of strategies, including directional equity long/short, market neutral, and multi-strategy, hedge funds can seek to profit in both rising and falling markets, in part because of the downside protection offered by short positions. Their dynamic approach and active risk management can make them a valuable tool for navigating volatility and protecting capital when traditional assets come under pressure.

A key caveat: private markets are less liquid.
With public markets, investors can exit all or a portion of their investments on any business day. Private market investments generally offer fewer windows when investors can exercise their right to sell. Before including private markets in their allocation mix, investors need to consider how much illiquidity they can tolerate

Conclusion: active management and alternative assets likely to be key solutions to today's critical problems

What is the optimal portfolio mix best suited to markets today and in the future? We see investors needing to address the following primary problem: *public market volatility will continue, and the correlation between public equity and bond markets will remain high*.

Trade wars, heightened geopolitical conflicts, more muted economic growth, persistent inflation, high interest rates, decarbonisation costs, and potential uncertainty about how the AI revolution will play out are likely to keep both the public equity and bond markets in a state of elevated volatility.

And the solution? Diversifying across alternative assets and continuing to deploy active management are likely to be key.

Alternative asset classes present unique risks (like the illiquidity risk in private markets) that may be unfamiliar to investors who have focused on traditional markets. Investors may need to find their own balancing point where they can tolerate some degree of additional risk to realise the benefits of potentially higher returns and greater diversification. Shifting economic conditions may affect public and private markets, and various sectors within them, quite differently.

Current conditions suggest a continuing high degree of return dispersion within asset classes, and that favours active managers who can be selective.

The best active managers are fully engaged in security analysis to help identify which investments can excel at any time and which are likely to be challenged. That careful and focused selectivity could make a considerable difference for investors in the market conditions we see today and for the foreseeable future.

Endnote:

1. Source: "The Trusted 60-40 Investing Strategy Just Had Its Worst Year in Generations," *The Wall Street Journal*, 10/19/23