CIO believes diversified asset allocations may help investors remain invested and effectively manage risks in adverse market scenarios. (UBS)

Diversified asset allocations may help investors remain invested

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The second quarter has begun with more lackluster market performance for both equities and bonds.The main causes of softer returns appear to be more muted expectations for how much the Federal Reserve can cut US borrowing costs.

Tepid performance at the start of this quarter does not undermine our expectation of positive returns for balanced portfolios in our base case and optimistic scenarios for 2024. Our base case remains for a benign outcome for markets—with inflation resuming its downward trajectory while growth moderates, allowing policymakers to cut rates.

But with geopolitics remaining uncertain and investors today grappling with a complex financial environment, we believe that diversifying across asset classes, regions, and sectors is the best way for investors to effectively manage the tension between short-term market dynamics and growing long-term wealth:

Diversification reduces risks. The UBS Global Investment Returns Yearbook, which analyzes financial markets going back to 1900, shows that a portfolio where equity investments were split across 21 countries would have experienced 40% less volatility than an average single-country stock investment. Similarly, a portfolio with a 60/40 split between stocks and bonds has historically been less volatile than one composed solely of stocks. Indeed, a 60/40 portfolio has only delivered a negative return over a five-year horizon on 5% of occasions, and never over a 10-year horizon (compared with 12%and 5% of the time, respectively, for equity-only portfolios).

Diversification helps catch the winners. It is also important to remember that diversification is as much about not missing the right stocks as it is about avoiding overexposure to the wrong ones. Over the past year, well-diversified investors have almost certainly benefited from the strong rally in AI stocks. Those with home-biased or concentrated portfolios may have missed out. Diversification is the best way investors can make sure they do not miss the outperformers, in our view. This is particularly important in an era of change.

Performance-chasing is dangerous. Our brains are hardwired to find patterns, even in random noise. We also have a strong recency bias that leads us to favor new information over older information. Together, these tendencies lead to performance-chasing behaviors that are undesirable in longer-term financial planning.

Looking at the annual returns of 14 major asset class returns since 1999, the prior year's best-performing asset class has had a roughly 40% chance of experiencing a loss in the following year, versus around a 30% chance of suffering a loss for a well-diversified portfolio.

So, we believe diversified asset allocations may help investors remain invested and effectively manage risks in adverse market scenarios. We recommend diversified strategic exposure to the technology sector as well as to some likely beneficiaries of tech disruption, and we think investors with excessive US big tech holdings should consider diversification opportunities in Asia's tech leaders and in quality companies across Europe and Asia.

We also believe alternative assets should be a key component of long-term portfolios for those who are willing and able to manage the inherent risks such as illiquidity. Additionally, systematic strategies can be particularly useful additions to traditional portfolios. Systematic strategies often apply a rule-based framework and generally rely on extensive data sets to derive investment positions. Unlike discretionary investing, systematic approaches are not influenced by human emotions.

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Original report - **Stay diversified amid a soft start to the second quarter, 3 April 2024.**