Unlocking Portfolio Resilience Through Diversification

. . Don't Put All Your Eggs in One Basket

As Harry Markowitz, the father of Modern Portfolio Theory, put it, "The only free lunch is diversification." This quote underscores one of the most fundamental principles of investing: managing risk and reducing volatility by spreading investments across assets and asset classes with distinct risk exposures.

Building Diversified Portfolios

A well diversified portfolio looks different for every investor. For those with an ability to withstand higher than average volatility, an equity-only portfolio with exposure to most of the 11 S&P 500 sectors may adequately manage risk as not all sectors move in the same direction at the same time. For example, during periods of rising interest rates, financial stocks tend to perform well, benefitting from improved net interest margins. By contrast, the technology sector may struggle, as higher borrowing costs squeeze profit margins and lower future growth expectations. The chart below displays the correlation between equity sectors and other asset classes over the past two years. Lower values indicate that the performance of the two variables largely moved independently, enhancing diversification benefits when both are included in a portfolio.

Diversification can also be achieved by investing across asset classes. While equities offer the potential for long-term growth, bonds typically provide stability and income. Adding exposure to real estate, commodities, or alternative investments introduces returns that often behave differently than traditional equities. The objective is to combine assets that do not move with a high degree of correlation, so that when one underperforms others help offset the impact. To this end, the accompanying graphic shows the dichotomy of equity and bond returns during volatile periods.

Common Investor Concerns

Diversification can be extremely valuable in boosting risk-adjusted returns, but harvesting these benefits typically involves assuming a degree of discomfort. We shed light on this by paraphrasing a few common investor laments.

"I am underperforming [asset A]"

Diversified portfolios will always underperform the best performing assets at a given time. Your investments may not garner much cocktail party attention but consider this the price you pay to reduce risk in pursuit of attractive long-term risk-adjusted returns.

"[Asset B] is way down, why do I still own it?"

Each investment should have strategic value in a well constructed portfolio. Point in time returns are rarely average, and it is not unusual for a single asset's performance to be far above or below the overall portfolio's return, or that of common market proxies. If you give up on an investment that has diversification value based merely on short-term performance, you may miss out on tomorrow's winner and/or compromise risk management.

"Why would I sell [Asset C] when it is performing so well?"

Outperforming assets may drift out of their target allocation range, thereby increasing aggregate portfolio risk. Rebalancing is designed to return position sizes to predefined ranges, thereby maintaining intended risk exposures.

Overcoming Behavioral Biases

Human instincts can betray us in investing. Many individuals crave certainty in an uncertain world and seek comfort in what has recently worked, even if that success may be fleeting. This innate tendency to chase performance or overreact to headlines makes it difficult to stay disciplined, especially when markets are volatile.

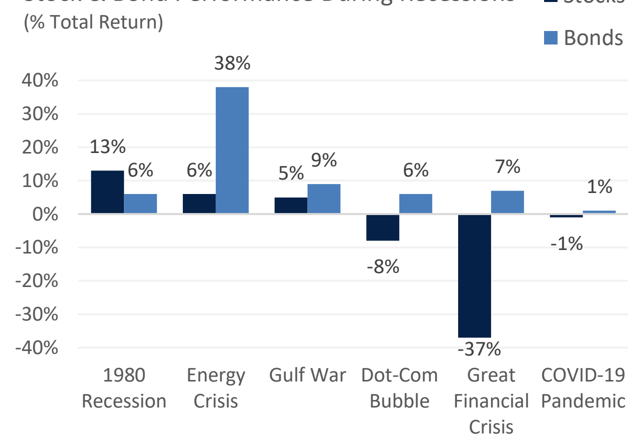
Diversification doesn't guarantee favorable performance, but it increases the odds of long-term success by spreading risk and enhancing portfolio efficiency. Doing so helps investors better weather storms, stay invested through volatile cycles, and take advantage of a broader set of market opportunities. Most importantly, it can serve as a behavioral anchor. Diversification is not always immediately rewarding, but much like a seatbelt, it tends to prove its value when you need it the most.

Weekly % Change Correlation Over the Past Two Years

	Telecom	Staples	Discretionary	Materials	Energy	Utilities	Technology	Healthcare	Real Estate	Industrials	Financials
Telecom	1.000	0.414	0.749	0.612	0.375	0.258	0.740	0.479	0.434	0.721	0.651
Staples	0.414	1.000	0.405	0.558	0.212	0.537	0.247	0.571	0.630	0.514	0.561
Discretionary	0.749	0.405	1.000	0.637	0.276	0.285	0.775	0.396	0.554	0.738	0.671
Materials	0.612	0.558	0.637	1.000	0.518	0.558	0.578	0.622	0.702	0.865	0.780
Energy	0.375	0.212	0.276	0.518	1.000	0.379	0.279	0.322	0.362	0.540	0.584
Utilities	0.258	0.537	0.285	0.558	0.379	1.000	0.209	0.412	0.653	0.484	0.538
Technology	0.740	0.247	0.775	0.578	0.279	0.209	1.000	0.408	0.399	0.742	0.570
Healthcare	0.479	0.571	0.396	0.622	0.322	0.412	0.408	1.000	0.580	0.610	0.592
Real Estate	0.434	0.630	0.554	0.702	0.362	0.653	0.399	0.580	1.000	0.652	0.649
Industrials	0.721	0.514	0.738	0.865	0.540	0.484	0.742	0.610	0.652	1.000	0.866
Financials	0.651	0.561	0.671	0.780	0.584	0.538	0.570	0.592	0.649	0.866	1.000

Source: Bloomberg, data as of 6/24/25

Stock & Bond Performance During Recessions
(% Total Return)



Source: JPMorgan, "Guide to the Markets – Q1 2025"

APPLETON PARTNERS, INC.

MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Q2 got off to a tough start as the "Liberation Day" tariff announcement led to broad market volatility. This policy uncertainty led the Fed to remain patient as they balance potential inflationary pressures with growing risk of economic weakness.
- April's municipal volatility was heightened by the seasonal tax effect and unusually large ETF selling pressures. Outflows led to underperformance vs. USTs and an early April rise in the 10-year AAA ratio into the low 80s.
- The market soon stabilized with the curve steepening over the remainder of Q2. AAA spreads between 2s and 10s increased from 58 bps to 68 bps, while the 2 to 30-year curve steepened from 156 bps to 196 bps.

	3/31/2025	6/30/2025	QTD Change
2-yr AAA Muni	2.68%	2.58%	-10 bps
10-yr AAA Muni	3.26%	3.26%	0 bps
30-yr AAA Muni	4.24%	4.54%	+30 bps

Source: MMD

- CME Fed Watch has 2 cuts priced in for 2025 and 3 in 2026. Goldman Sachs expects 3 cuts in 2025 and 2 more in 2026, which would lead to a terminal Fed Funds rate of 3.00-3.25%. We anticipate at least 1 cut in 2025, but not likely until the October meeting.
- Q2 municipal issuance initially took a brief trade policy induced respite, although this year's record pace quickly got back on track. YTD issuance of $280.6B is now 14.3% ahead of last year's pace according to Bond Buyer.
- Strong demand is helping the market easily absorb new supply. YTD net fund flows totaled $9.5B with municipal ETFs accounting for 90%. Intermediate and short strategies have gathered the lion's share of inflows.
- Valuation improved over May and June with 10-year AAA Muni/UST ratios ending Q2 at 77.36%.
- Tax-exempt IG spreads remain tight and ended Q2 unchanged at +11, +35 and +83 bps for AA, A, and BBB credits (Bond Buyer).
- Q2 curve steepening was driven by lower yields from 1 to 9 years and rising yield levels beyond 10 years. Duration drove performance with the Long Bond (22+ years) the worst index component (-1.94%), while the 5-year index was up +1.35%.
- Quarterly GDP growth has slowed to about +1%, employment gains are lagging, and the housing market is struggling. Fed Funds cuts are forthcoming – it's just a matter of when – and this should support a steeper muni curve.
- Although yield volatility may persist, our Intermediate duration target remains at 4.65 years, and we are focusing on 2 to 12-year bell-shaped curve exposure.

Investment Grade Corporates & Treasuries

- The stability of IG credit spreads during Q1 quickly changed as uncertainty around a shifting tariff landscape shook the markets to begin Q2. Once the market had an opportunity to digest the news, that sentiment reversed rapidly. YTD high spread levels of 4/8 turned sharply tighter through the end of the quarter. The 83 bps OAS on the Bloomberg US Credit Index was 10bps lower than where we began the quarter and just 10 bps off YTD lows.
- While spreads are compressed, further near-term tightening is possible as strong demand and market technicals remain intact.
- Issuers have found it opportunistic to come to market as demand pushed new issue premiums lower along with falling rates. The $366.7B of new Q2 supply was 8% higher than Q2 '24, bringing total 2025 issuance to $897.7B, 3.5% greater than 1H '24. The potential for sustained inflationary pressures could change current issuance dynamics although strong technicals should persist.
- The UST curve steepened as yields in the 2 to 5-year part of the curve dipped lower and benchmark bonds beyond 15 years ticked higher. The stability of the 10Yr bond made it the pivot point. A 4.23% 10Yr print on 06/30 was just 3 bps below where the quarter began although it is now 30 bps lower YTD.
- Accelerated volatility seen in early April soon subsided and rates acted orderly as the quarter moved along, although domestic headlines and global tensions periodically jolted sentiment. These factors should continue to be headwinds as the year progresses.

Equities

- In a historic turnaround, the S&P 500 finished Q2 with a gain of +10.6%, the best quarter since Q4 '23. This came despite one of the worst 2-day periods in history in early April (-10.5%) and a -19% drawdown from its February all-time high.
- Sector performance varied with Tech (+23.5%) and Comm. Services (+18.2%) significantly outperforming Energy (-9.4%) and Health Care (-7.6%). The "Mag 7" rose +20.9% while the equal-weighted S&P 500 trailed the headline index by 5.6% as breadth narrowed.
- Investors have climbed a proverbial "wall of worry." While the ultimate impact of tariffs remains to be seen, a softer tone has been welcomed. The Israel/Iran conflict appears to have ended without a worst-case scenario, while the tax bill passed in early July. The Fed, though remaining on hold, has also sounded a bit more dovish of late.
- Investors have accordingly been in a "risk-on" mode with market exposures seen as lower quality faring best.
- Drivers of 2H performance are likely to come from corporate earnings and guidance, trade relations, and the impact of pending inflation and labor market data on Fed policy.