APPLETON PARTNERS, INC.

Back to the Future: Will There Be a Balanced Strategy Resurgence?

> ***"The enduring strength of the 60/40 portfolio suggests that investors looking to build diversified portfolios don't necessarily need to venture too far beyond a basic mix of larger-cap stocks and high-quality bonds."***
>
> (Morningstar, April 2026)

Human nature often drives us to project forward what has most recently occurred, a phenomenon known as recency bias. Placing too much emphasis on the immediate past can distort our perception of the future. Behavioral finance tendencies of this nature are pervasive, and the last several years offer a good example.

Balanced strategies have long been a mainstay of asset allocation, a construct supported by the conventional wisdom of diversification. Confidence in this approach was severely tested though from 2022 to 2024 as traditionally negative correlations between stocks and investment-grade bonds turned positive. When bonds failed to buffer equity exposure, and both asset classes produced negative returns, many advisors soured on the concept.

What Went Wrong?

Before defending the methodology, let's briefly look at why it has not performed as expected over much of the 2020s. COVID-related supply chain shocks coupled with aggressive federal stimulus sent inflation soaring early in that period, which in turn triggered the most aggressive interest rate hikes in decades in 2022 and 2023. As investors grappled with recession fears and spiking interest rates, stock and bond prices simultaneously declined, causing their correlation to turn positive. For a brief time this spring, a similar dynamic played out as the Iran War caused a surge in geopolitical risk and energy prices, along with renewed inflation concerns. Fortunately, fears have moderated, and markets, while volatile, are holding up well, yet asset allocation questions linger. Is the old model becoming dated?

An Abridged Explanation of Diversification

A key tenet of portfolio theory is that assuming greater risk creates the potential for greater return. However, aggregating the risk and return characteristics of underlying investments is not simple arithmetic. Within an asset allocation plan, combining investments with low or negative correlation can reduce overall portfolio risk as these assets are unlikely to experience downturns at the same time. By contrast, the expected return of the entire portfolio is derived from the weighted average of each asset class's expected return. Therefore, a risk-related benefit of high-grade bonds in a diversified portfolio lies in how they interact with other exposures.

Why Take a Balanced Approach?

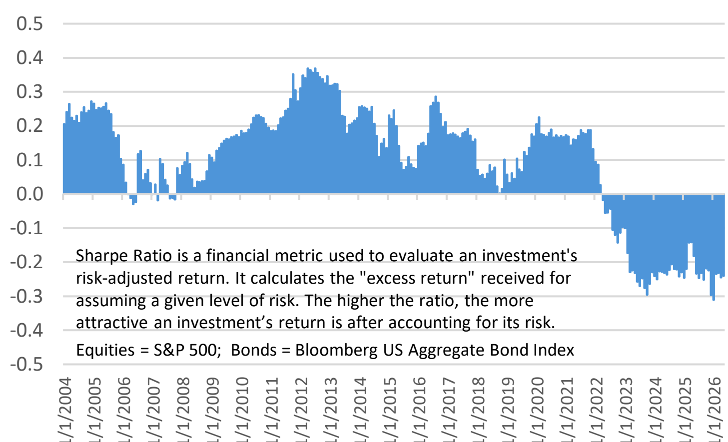
Readers of Quarterly Perspectives are likely well versed in the goal-oriented nature of Appleton's private client services. Wealth management is inherently personal, with each client's objectives and risk tolerance shaping their investment plan. For this reason, we often recommend balanced strategies. While the equity exposure and underlying asset mix vary, the fundamental objective is to tailor asset allocation around individual financial objectives.

Including a high-quality bond allocation provides income that may be needed for retirement or to offset other future liabilities. It also provides a shock absorber that can help investors more comfortably withstand the inevitable volatility of riskier asset classes such as equities.

Experience tells us that emotional reactions to global events and market conditions are likely to be counterproductive. However, attempting to protect against these risks during a downturn can be too late. A more effective approach is to establish a diversified asset allocation strategy at the outset that addresses long-term objectives and reduces the likelihood of selling at the wrong time.

As we've long emphasized, sustained exposure to equities offers tremendous capital appreciation potential, yet this is best achieved through time in the market, not market timing. We believe that managing portfolio risk, in part through balanced portfolio construction, allows for greater comfort in staying invested, even when correlations occasionally turn positive.

Rolling 3-Year Sharpe Ratio:
60/40 Balanced Portfolio vs. S&P 500



Asset Class	Ann. Return	Ann. Volatility	Sharpe Ratio
Equities (SPX)	9.48%	15.00%	0.53
Bonds	3.66%	4.21%	0.46
60/40 Blend	7.50%	9.09%	0.62

Source: Bloomberg and Appleton Partners, Inc.

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MARKET OBSERVATIONS & IMPLICATIONS

Tax-Exempt Investment Grade Municipals

- Q2 began with geopolitical headwinds and inflation concerns after a tough March. However, higher yields at the end of Q1 helped set up for strong municipal performance in Q2.
- AAA yields were lower by 8-17bps in the 5 to 10-year range. Concerns that the Fed may be increasing rates later in 2026 and/or 2027 kept front-end yields muted. The 2 to 10-year AAA spread fell from 70bps to 61bps.

	3/31/2026	6/30/2026	QTD Change
2-yr AAA Muni	2.42%	2.35%	-7 bps
10-yr AAA Muni	3.12%	2.96%	-16 bps
30-yr AAA Muni	4.47%	4.19%	-28 bps

Source: MMD

- Municipal issuance fell just short of $300B by quarter end, with the YTD increase of 5.2% ahead of 2025 levels. Taxable municipal issuance declined 2.4%.
- Quarterly fund flows of $27.3B increased YTD inflows to $53.3B, the 2nd highest year on record. Long Duration funds garnered 70%, with Intermediate gathering 21%.
- Municipals outperformed USTs in Q2, bringing the 10-year AAA Muni/UST ratio to 66.0%, down from 72.2% at the end of Q1.
- With yields lower on the quarter, the Long Bond Index (22+ years) was the best performer at +4.19%, while the 1-year Index lagged at +0.76%.
- 10-year AAA-AA and AAA-A credit spreads were unchanged at 11bps and 29bps, respectively, while AAA-BBB spreads of 75bps tightened by 2bps.
- Strong credit carry led lower grade sectors such as Hospitals, Housing, and Special Tax to outperform. The BBB portion of the Index was the best performer at +3.44%.
- Despite some Q2 flattening, the curve remains relatively steep and provides ample opportunity for total return and roll. Our Intermediate duration target remains at 4.80 years, and we are targeting bell-shaped curve exposure in anticipation of further steepening. We do not expect 2026 rate hikes and see modestly more attractive ratios over the next few quarters.

Investment Grade Corporates & Treasuries

- Ultra-short UST rates climbed materially higher over the quarter as a curve flattening trend continued. The benchmark 2Yr UST rose 38bps to close at 4.18%, with 3Yr USTs ending up at the same yield, up 37bps. Further out on the maturity spectrum, the 10Yr benchmark rate closed at 4.47%, just 15bps higher than where it began the quarter.
- The rise in short-term rates has compressed the spread between shorter and longer bonds, with 2 to 10-year spreads now at just 29bps, the narrowest it has been since April 2025. The market has priced in the potential for one rate hike by the Federal Reserve by year-end and until that sentiment abates, the bear flattener trend may continue.
- Issuers are taking advantage of an appetite for high quality bonds. June's $175B of new debt set a new record following very robust March and April issuance. Tech issuers have been very active with debt offerings that fund projects tied to the AI spending spree. The first half of 2026 has tied 2020's record-setting volume pace.
- US Investment Grade credit spreads moved tighter in Q2. Bloomberg US Corporate Bond Index OAS began at 89bps and bounced along before closing at 74bps. That is 4bps lower than where 2026 began and only 3bps off the YTD tights. We continue to feel that breakouts or abnormalities in credit spreads remain unlikely over the near term given investor demand and credit strength.

Equities

- Stocks moved higher in Q2, with the S&P 500 (+14.9%) and Nasdaq (+21.4%) both posting their best quarters since Q2 2020. For the S&P 500, Q2 was the 12th best quarter dating back to 1950. The DJIA underperformed, gaining +12.9%, but closed at a fresh all-time high. Small cap stocks shined with the Russell 2000 gaining +21.2%, its 8th best quarter since the inception of the index in the 1970s.
- Although breadth expanded in June, the equal-weight S&P 500 (+10.9%) trailed the market cap-weighted index by 401bps in Q2. Only Technology (+31.6%) outpaced the broader index with Industrials (+14.5%) the only other sector up >10%. Despite the strong quarter, 3 sectors finished in the red, with Energy (-14.0%) the laggard as WTI crude dropped -31.4%, including a -20.4% decline in June, its worst month since November 2021.
- Artificial intelligence remained a dominant market theme in Q2, as robust spending on data centers led to further strength in semiconductors, power generation, and cooling. The SOX index, which tracks a basket of semiconductor chips, gained 88% for Q2, its best quarter since its creation in 1993. DRAM, a memory chip ETF, nearly doubled that with a 166% gain. It was these baskets, not the "Mag 7" (+10.9%), that drove Tech outperformance in Q2.
- Geopolitical headlines dominated markets throughout the quarter as the conflict in Iran carried on. Investors were able to look past the impact of higher oil prices due largely to underlying strength in corporate earnings. S&P 500 earnings grew +28.6% YOY, well above the +13.1% expected as of 3/31. Net profit margins also expanded to a record 14.8%. Despite stocks trading near all-time highs, surging earnings drove valuations down with the S&P now trading at a 20.1x forward P/E vs. ~22x entering the year.

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