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The Long View: Diversification for Uncharted Waters

*"Diversification is the only free lunch in investing."
– attributed to Harry Markowitz*

Key Takeaways

- ▶ A digestion period for U.S. stocks was not unexpected coming into 2025, with the third year of a bull market typically experiencing more muted returns. Unfavorable policy sequencing that prioritized tariffs first before tax cuts by the Trump administration has further contributed to equity market volatility.
- ▶ While U.S. equities have outperformed over longer time horizons, international stocks tend to pick up the slack when domestic markets falter. A rotation out of the Magnificent Seven and into international, value and dividend growers highlighted the power of diversification during the first quarter.
- ▶ The economy and markets are entering uncharted waters and policy uncertainty appears likely to remain elevated in the near term. This only further underscores the benefits of diversification for equity investors.

Entering Uncharted Waters

The first three months of 2025 marked the worst quarter for the S&P 500 Index since 2022, bringing the benefits of diversification back to the fore. Then came the Trump administration's "Liberation Day" tariff announcements on April 2, which led to a new round of selling as the announced tariff rates exceeded even the most pessimistic expectations. Much remains unknown including the possibility of trade deals being reached. However, with the economy and markets entering uncharted waters, the balance of economic and market risk has shifted unfavorably, in our view. The ClearBridge Recession Risk Dashboard remains in overall green "expansionary" territory, but [similar to the early days of the COVID-19 pandemic](#), many indicators on the dashboard do not yet reflect what is currently happening.

There is one change on the dashboard this month with ISM New Orders worsening to red following last month's deterioration to yellow. Deteriorating business (and consumer sentiment) has been one of the key risks emerging given the elevated uncertainty over the past few months, but the degree to which weaker "soft" survey data translates into poor "hard" results will be critical. Looking ahead, we would expect indicators like Credit Spreads — which are currently

nearing yellow territory — and Commodities to be the first areas to roll over.

Exhibit 1: U.S. Recession Risk Indicators

		March 31, 2025	February 28, 2025	January 31, 2025
Consumer	Housing Permits	↑	↑	↑
	Job Sentiment	×	×	×
	Jobless Claims	↑	↑	↑
	Retail Sales	↑	↑	↑
	Wage Growth	↑	↑	↑
Business Activity	Commodities	↑	↑	↑
	ISM New Orders	×	●	↑
	Profit Margins	↑	↑	↑
	Truck Shipments	●	●	●
Financial	Credit Spreads	↑	↑	↑
	Money Supply	↑	↑	↑
	Yield Curve	×	×	●
Overall Signal		↑	↑	↑

↑ Expansion ● Caution × Recession

Data as of March 31, 2025. Source: BLS, Federal Reserve, Census Bureau, ISM, BEA, American Chemistry Council, American Trucking Association, Conference Board, and Bloomberg. The ClearBridge Recession Risk Dashboard was created in January 2016. References to the signals it would have sent in the years prior to January 2016 are based on how the underlying data was reflected in the component indicators at the time.

Based on the dashboard alone, the probability of a recession over the next 12 months is in the neighborhood of 35%, a figure we are subjectively increasing to 50% due to the worse-than-expected tariff announcement and our perception of risks skewing negative for the economy and markets. Our assessment of the economy begins with the dashboard but incorporates many tools as well as our own judgement and experience, along with that of our colleagues at ClearBridge. In speaking with our colleagues over the past few days, three words best encapsulate the recurring themes across those conversations: skepticism, unknowns and diversification.

Skepticism and unknowns are specific to the current environment; skepticism regarding the near- and intermediate-term consequences of recent policy decisions, which the market is signaling may be worse than the administration believes. Unknowns on the positive side include the potential for more market-friendly policy developments such as trade deals and the possibility that tariff revenue is used to fund larger than expected tax cuts. Conversely, there are risks that the long-term benefits the administration is seeking may fail to offset the associated costs. This line of thinking drives our perception of an unfavorable risk skew, which leads to the third recurring theme: diversification.

Allocate Across Geographies, Sizes and Investment Styles

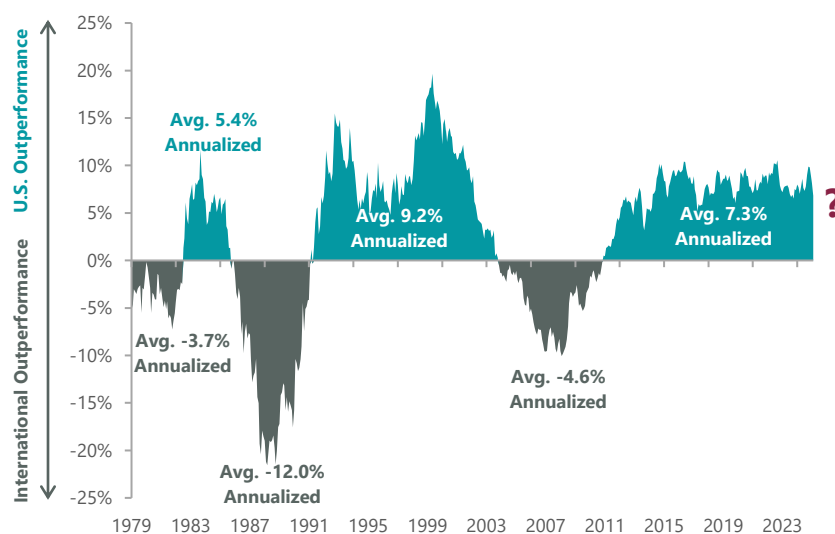
Over the past several years, diversification has felt less like the free lunch described by Nobel Laureate and modern portfolio theory pioneer Harry Markowitz, and more like a drag on returns. This has

been a headwind to active managers as a narrow group of stocks powered most of the benchmark's upside. However, our colleagues have stuck to their knitting in building diversified portfolios (generally with a quality bias) which is now paying off. According to research firm Strategas Research Partners, 59.8% of active managers outperformed in the first quarter. If that were to hold up for the balance of the year, it would mark the second-best year for active managers since the Global Financial Crisis (GFC).

The importance and benefits of diversification apply at many levels, a fact many investors were reminded of in the first three months of the year with the previously red-hot Magnificent Seven stocks falling - 16.4% while left-for-dead international equities (MSCI All Country World Index ex-US) rose 4.6%. Constructing a diversified portfolio entails more than just geographic allocation, however, with market cap and investment style important considerations as well. While the relative outperformance of non-U.S. stocks has garnered the lion's share of headlines lately, value stocks in the S&P 500 have outperformed their growth counterparts by 11.7% so far in 2025. Part of the reason that geographic leadership has been in focus, however, is that it stands in stark contrast to consensus expectations coming into the year that U.S. equities would handily outpace their international peers once again.

Geographic leadership tends to persist for much longer than investors generally appreciate. U.S. stocks have consistently outperformed their international peers dating back to the GFC. While this sounds remarkable, it is hardly unprecedented, with a somewhat shorter but meaningfully stronger period of U.S. leadership occurring throughout the 1990s and into the early 2000s.

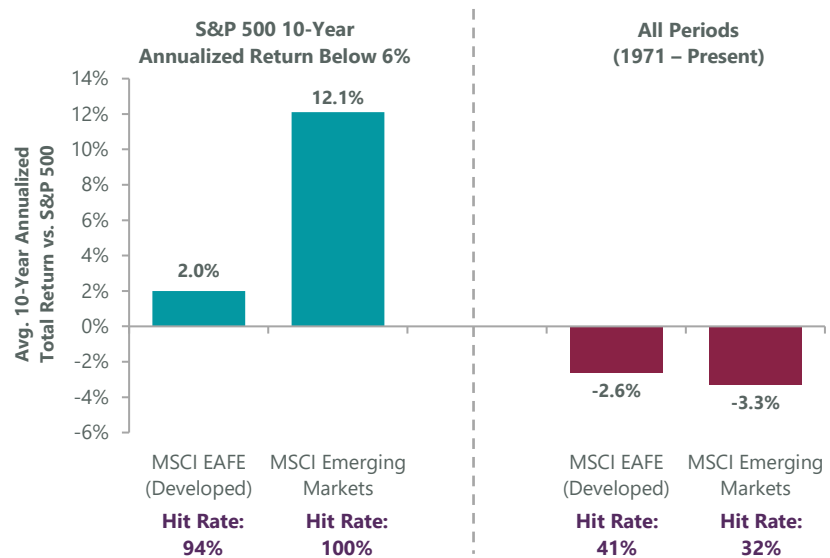
Exhibit 2: Global Leadership Cycles



Note: Data shows rolling five-year annualized performance differential between S&P 500 and MSCI ACWI ex-U.S. indices. Data as of March 31, 2025. Sources: FactSet, S&P, MSCI.

Historically, international equities have provided the greatest diversification benefits when U.S. stocks have been challenged. While this can occur on a short-term basis like what we've seen recently, the effect is magnified over longer time horizons. Since 1971 when the S&P 500 has delivered less than 6% annualized over a 10-year period, the MSCI EAFE (developed) and the MSCI Emerging Markets indexes have outperformed by an average of 2.0% and 12.1%, annualized, respectively. Importantly, the hit rate for outperformance is greater than 90% for each benchmark. Although the U.S. has outperformed over the long haul, international equities tend to pick up the slack when U.S. markets falter.

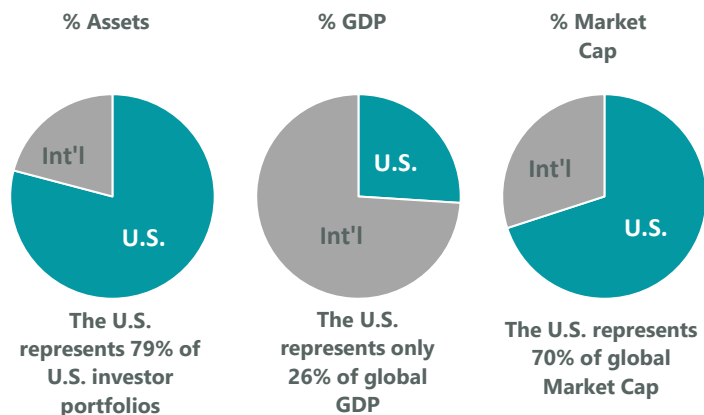
Exhibit 3: Diversification Matters



Note: Data shows 10-year rolling monthly periods.
Data as of March 31, 2025. Sources: Morningstar, S&P, MSCI.

This is an important component of diversification: by garnering exposure across asset classes, long-term returns can be improved by reducing portfolio volatility. This helps to smooth out returns as leadership cycles tend to ebb and flow. One dynamic helping support investor focus in non-U.S. stocks is relative valuations, with the cohort still trading near 25-year lows to U.S. peers even after this year's robust outperformance. Importantly, U.S. investors are quite underweight international equities while non-U.S. investors have poured over \$9 trillion into U.S. stocks over the past five years, according to research from Apollo. Should these flows reverse, it could lead to continued upside for the group, bolstering the diversification benefits.

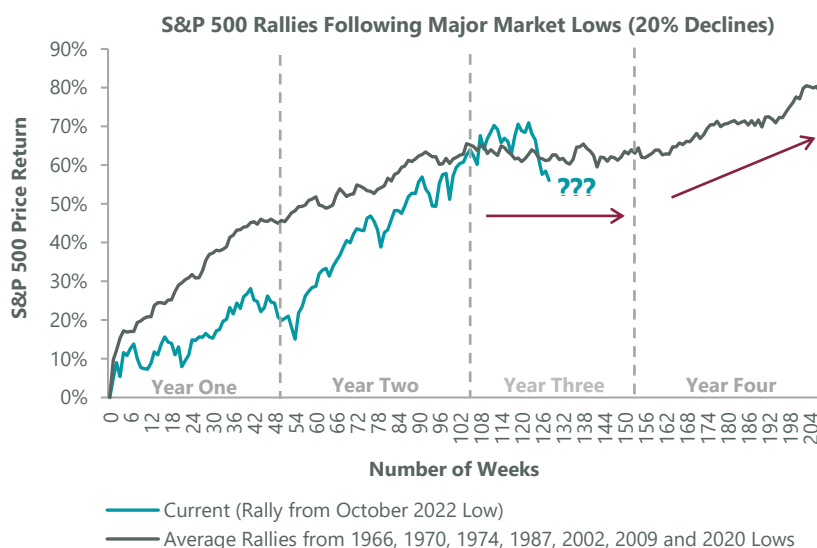
Exhibit 4: Home Country Bias



Morningstar Category Assets as of Feb. 28, 2025. GDP as of Dec. 31, 2024. MSCI World Index as of March 31, 2025. Sources: Morningstar, IMF, MSCI, FactSet. Data most recent available as of Mar. 31, 2025.

Trade turmoil aside, recent equity market weakness and the leadership rotation have also been driven by other unrelated dynamics including crowded positioning and the potential for AI capex rationalization. One underappreciated aspect may be the typical maturation of the bull market, with new bull markets (those following -20% declines) experiencing a period of digestion during their third year before seeing a resumption of the rally in year four. The current bull market had its third birthday approximately six months ago, meaning we are square in the middle of the historical digestion period.

Exhibit 5: The Year-Three Digestion

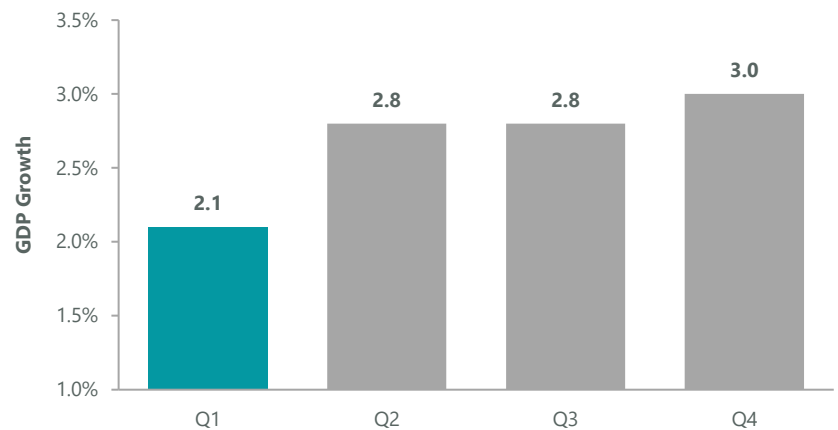


Data as of March 31, 2025. Sources: FactSet, S&P Global.

While the trade war and policy uncertainty are all but certain to weigh on revenue growth, profit margins and ultimately earnings, the economy has been on solid footing with consumer spending holding

up and a healthy labor market. A soft patch appeared to be emerging even before policy uncertainty became elevated, which is a typical dynamic as the first quarter has been the weakest of the year over the past ~15 years. This was likely amplified in 2025 by unfavorable weather and a tough flu season — January was the coldest since 1988 and the flu season was the worst since 2010 — meaning the economy may be facing a larger-than-normal soft patch to begin the year, but also that the source of some weakness is likely to fade as we move through the year.

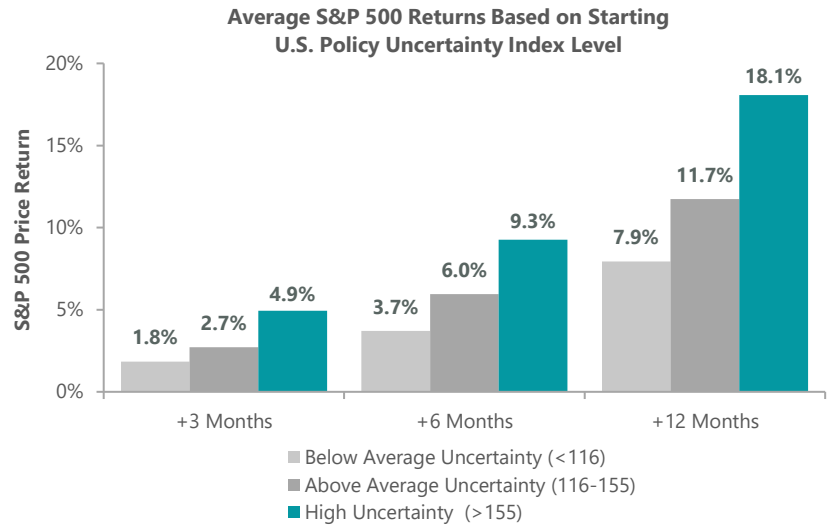
Exhibit 6: 1Q Growth Score Common



Note: 2010-present, ex-2020. Sources: U.S. Bureau of Economic Analysis (BEA), Macrobond. Data as of March 27, 2025, latest available as of March 31, 2025.

The primary driver of recent market weakness — and one that is certainly not underappreciated — has been elevated policy uncertainty, however. Coming into the year, our view was that policy sequencing presented [a risk of first-half choppiness](#) as the administration prioritized less-market-friendly policies (tariffs, immigration, DOGE) before turning to more market-friendly goals (tax cuts, deregulation) later in the year. Should visibility emerge in the coming months and uncertainty fade, one overhang on U.S. equities would ebb. Historically, when the U.S. Policy Uncertainty Index, a measure compiled by financial economists at three leading universities, has been high (above 155), as is the case today, the S&P 500 has delivered average returns of 9.3% over the subsequent six months and 18.1% over the subsequent 12 months.

Exhibit 7: Certainty in Uncertainty



Note: Data shown from 1985 – present. Data as of March 31, 2025. Sources: Macrobond, S&P, FactSet, Economic Policy Uncertainty.

Policy uncertainty tends not to remain elevated for sustained periods. However, should it remain so in the coming quarters, past trends may not be realized. This is a distinct possibility due to the harsher and broader than expected Liberation Day tariff announcements. Although volatility will likely remain elevated as market watchers attempt to parse out the economic implications and ultimate settling point for tariffs should trade negotiations progress, investors have typically been rewarded as policy normalizes.

One way to help navigate through a period of elevated uncertainty is to focus on higher-quality companies with proven track records managing through periods of turmoil. Focusing on companies with a consistent ability to increase their dividends — a byproduct of being able to grow profits throughout the ups and downs of a cycle — is one such approach. These types of equities had been out of favor in the U.S., experiencing a period of historically large underperformance relative to the broader benchmark. Following similarly large periods of underperformance in the late 1990s and early 2020s, dividend growers went on to pull ahead of the benchmark in subsequent years, making their recent run an encouraging sign.

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