## Market Insights: Moving Beyond the Style Box

In a market environment where uncertainty and volatility seem ever-present, the fundamental need for genuine portfolio diversification has rarely been more critical. Most investors understand the basic idea of diversification: do not put all your eggs in one basket.

The misconception shows up in how it gets implemented. Many equity portfolios are built like a checklist of categories, then labeled diversified. But labels are not return drivers, and a portfolio can look diversified on paper while still being dominated by the same underlying risk. This matters most in periods of market stress, when correlations – how investments tend to move together - across traditional categories tend to rise, with values near 1.00 moving together, near 0.00 moving independently, and below 0.00 often moving in opposite directions.

## Different Boxes, Similar Engines

A simple way to see the issue is to compare common equity sleeves that look distinct on paper: large cap growth and large cap value, small cap growth and small cap value, international developed equities, and emerging markets equities. These sleeves are often treated as different sources of return. In reality, they are frequently driven by the same dominant engine: equity market beta, plus shared exposure to liquidity conditions and risk sentiment.

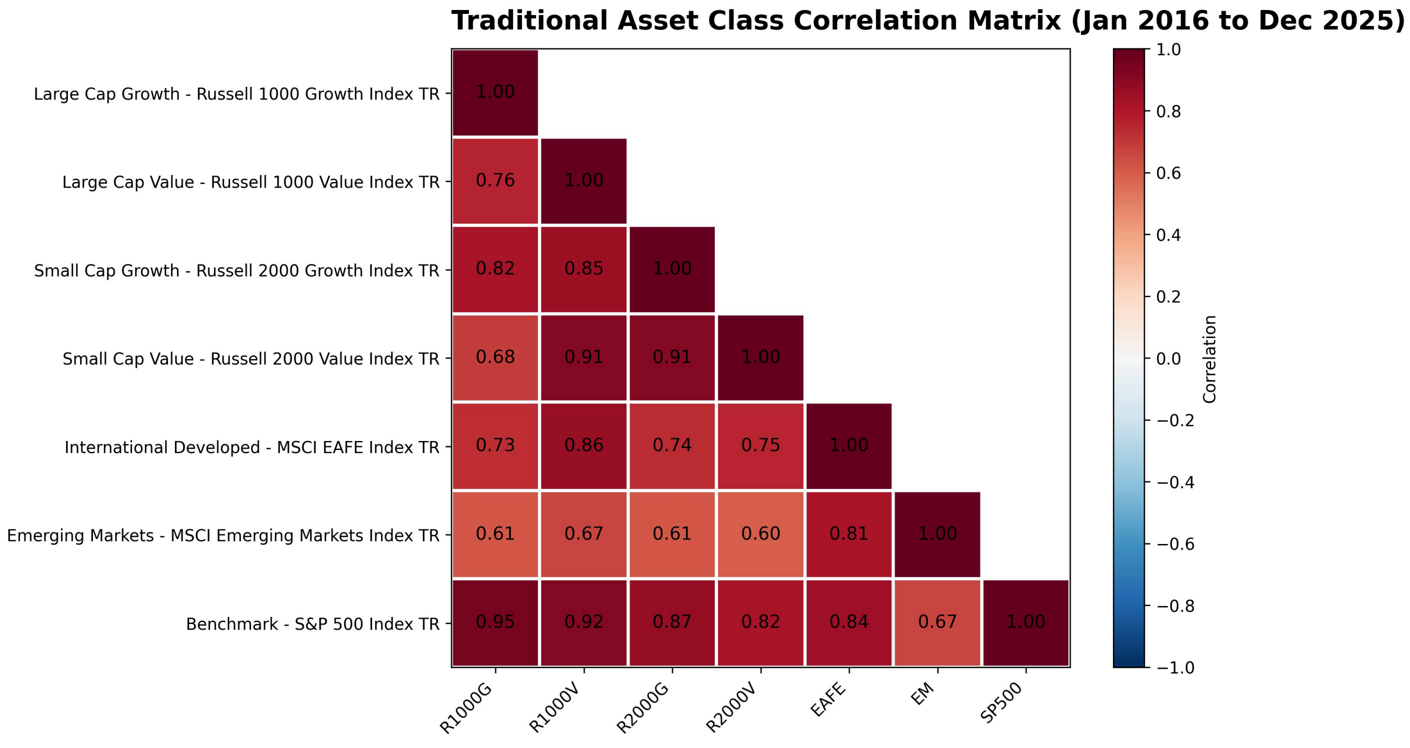


*Figure 1. Correlation heatmap of major equity style and regional indices, Jan 2016 - Dec 2025.*
*Source: Morningstar Direct*

From January 2016 through December 2025, the six primary equity sleeves in Figure 1 demonstrated a surprising truth: they were tightly linked. The average pairwise correlation sat at a high 0.91, with none falling below 0.60. Even the least-related pair in the set, Russell 2000 Value versus Emerging Markets, still moved significantly in tandem. When compared to the broad market anchor, correlations to the S&P 500 were consistently high, ranging from 0.67 (Emerging Markets) to a very tight 0.95 (Russell 1000 Growth).

## The Stress Test is Where the Myth Breaks

The bigger issue is not that correlations are elevated in normal times. It is that many investors assume those relationships will hold when markets are stressed. Recent periods of market turbulence serve as a timely reminder that correlations often converge precisely when diversification is needed most. In practice, correlations are not static, and they can tighten significantly during drawdowns.

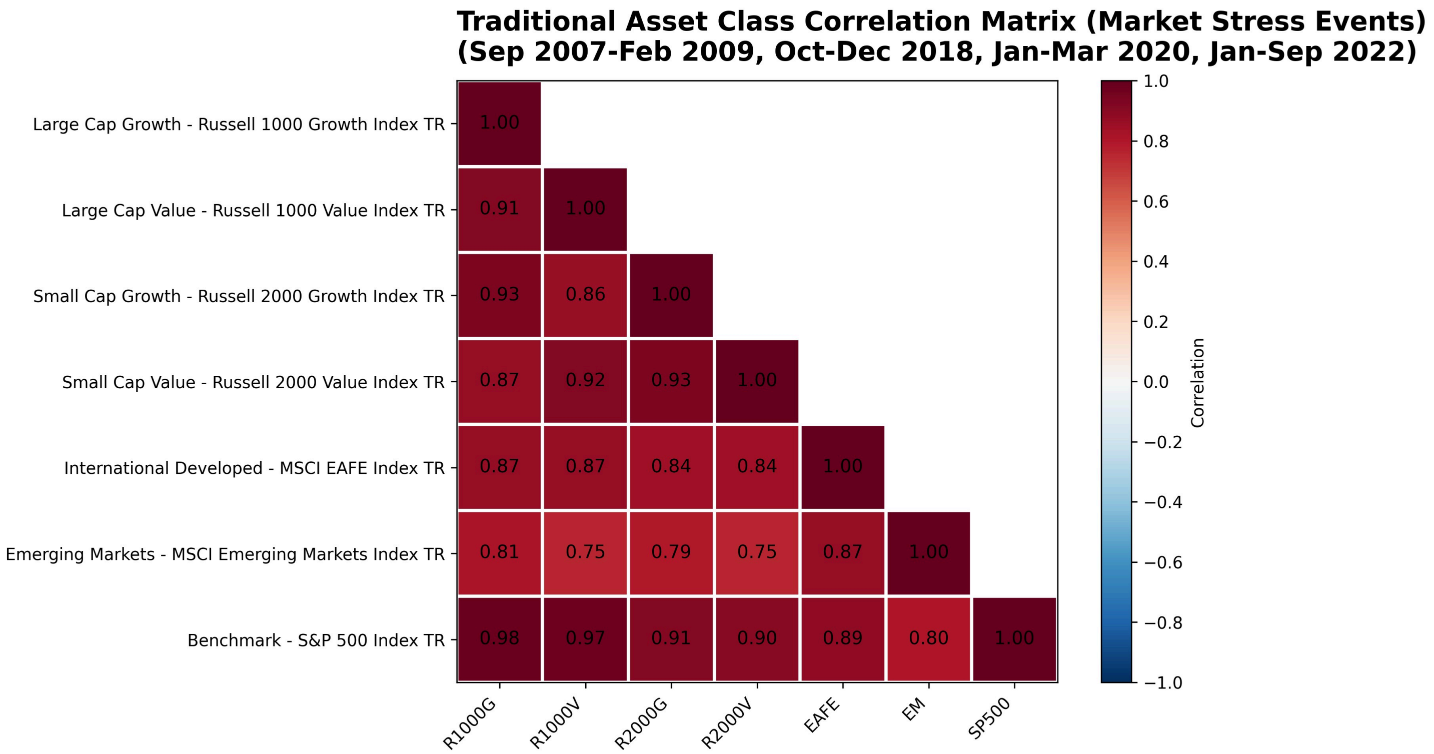


*Figure 2. Correlation heatmap of major equity style and regional indices, (Sep 07-Feb09, Jan22-Sep22, Jan20-Mar20, Oct18-Dec18).*
*Source: Morningstar Direct*

Across the four stress windows reviewed, the average pairwise correlation for traditional equity sleeves rose materially to 0.85, up from 0.75 in the full time sample. This highlights the diversification challenge in plain terms: a portfolio might look balanced in calm markets, but the relationships often converge when markets are under pressure.

## Upgrading the Diversification Test with More Return Engines

If traditional equity sleeves tend to converge in stress, the next step is to broaden the toolkit beyond labels and add return engines intended to behave differently than long-only equity beta. With a broad index library, this framework moves from concept to measurement. The goal is to add return sources with drivers that are intended to be structurally different from long-only equity beta and may behave differently across market environments.

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A clean, index-based return engine lineup (as shown below):

- Trend/Managed Futures - SG Trend Index
- Equity Market Neutral - BarclayHedge Equity Market Neutral Index
- Gold - S&P GSCI Gold Index
- Broad Commodities - S&P GSCI Commodity Index
- Absolute Return - HFRX Absolute Return Index

Two notes. First, hedge fund and alternative indices can have reporting, construction, and investability nuances. Treat them as benchmarks for behavior, not as direct implementation vehicles; indexes are unmanaged and cannot be invested directly. Second, the point is not that these exposures always hedge equity risk. The point is that they introduce different return drivers, which may improve overall portfolio resilience when traditional equity sleeves become more synchronized.

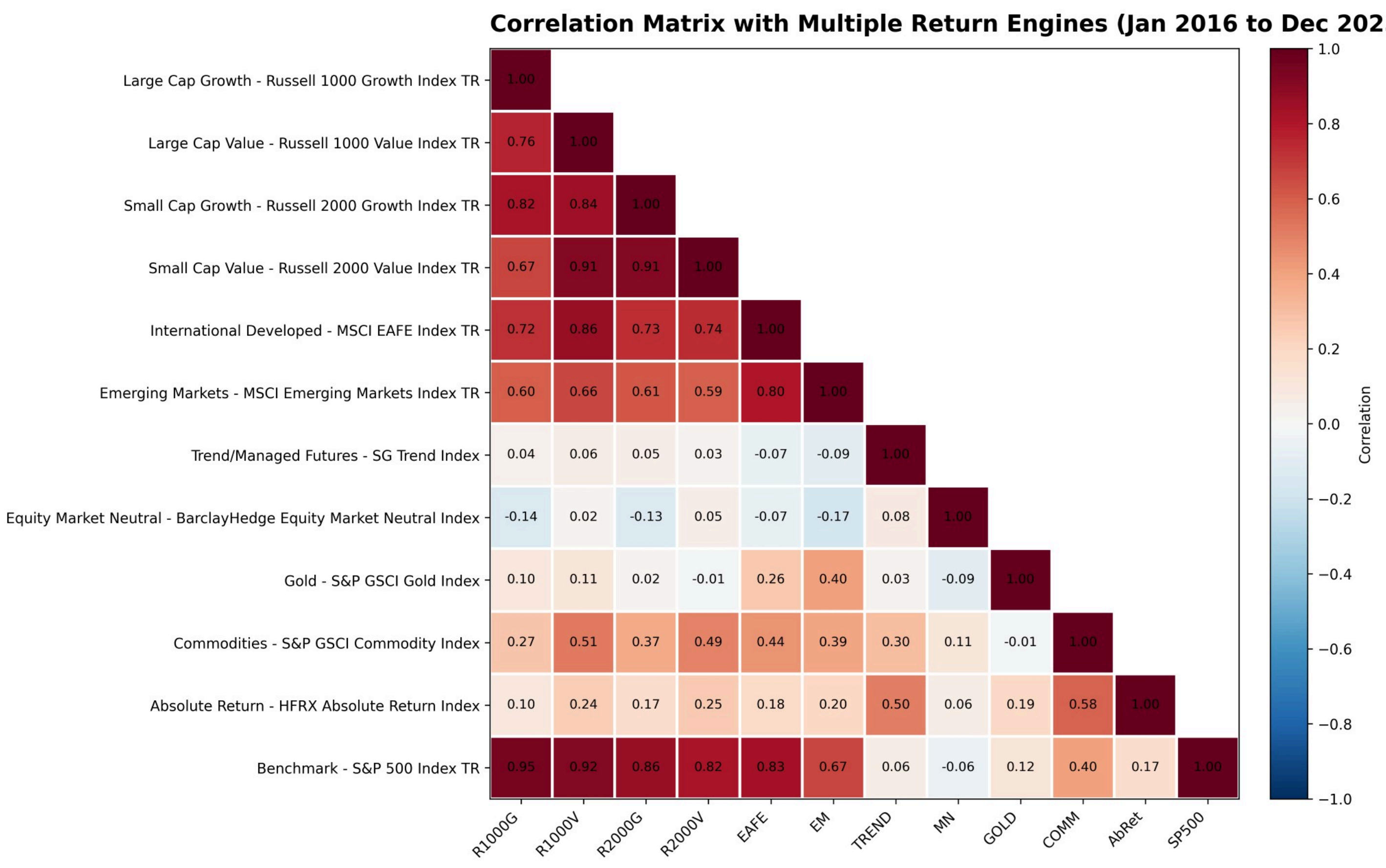


*Figure 3. Correlation matrix including return engines, Jan 2016 - Dec 2025.*
*Source: Morningstar Direct*

Figure 3 highlights why return engines matter. Traditional equity sleeves remain tightly linked to one another and to the broad market, while several alternative engines historically show much lower, and in some cases negative, correlations to equities. That is what diversification looks like when it is driven by different return sources, not just different labels.

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Figure 4 applies the same expanded lens to same stress periods. The traditional sleeves remain highly synchronized, while several return engines show low or negative relationships to equity beta during drawdowns.

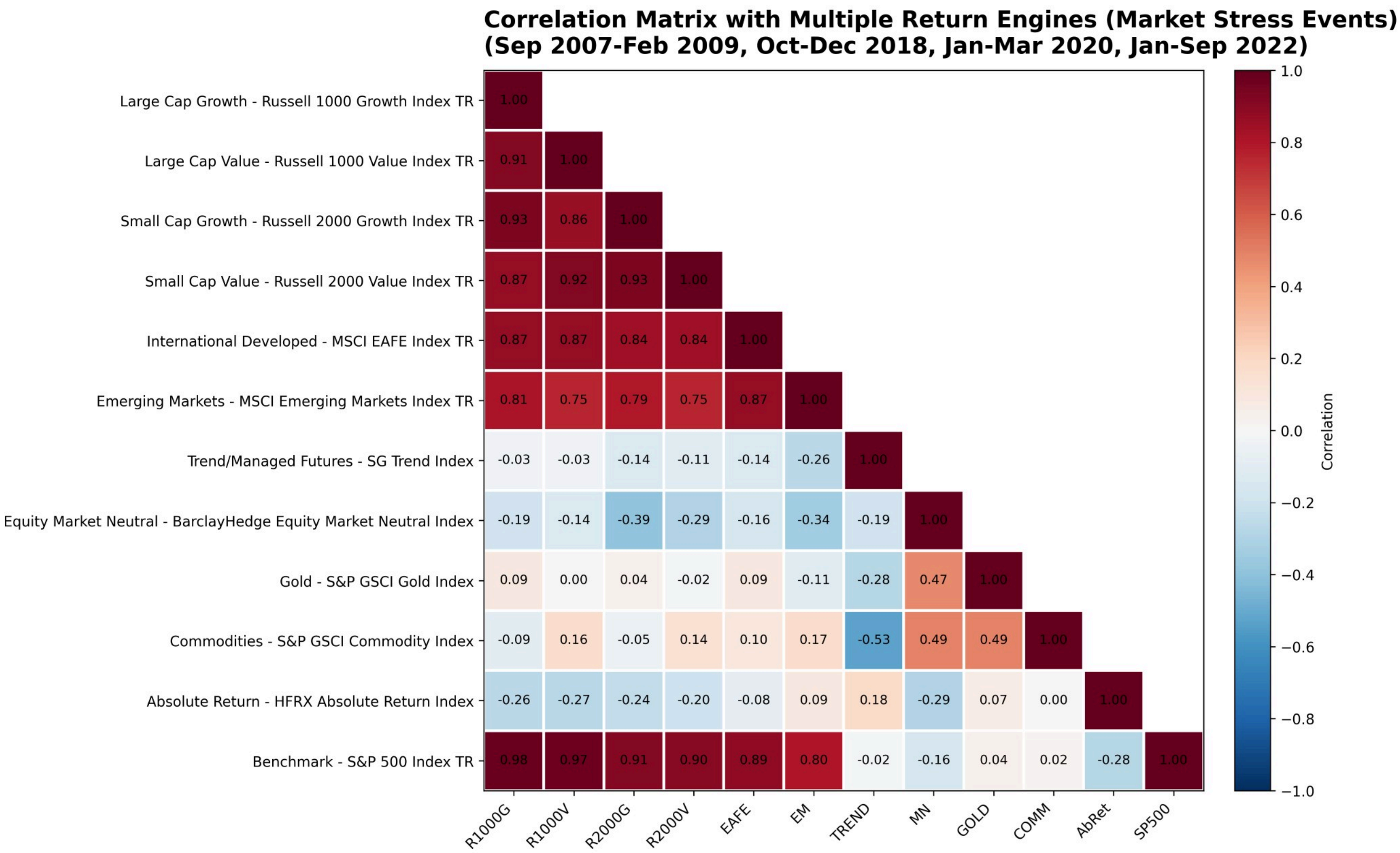


*Figure 4. Correlation matrix including return engines, market stress events (Sep 2007-Feb 2009; Oct-Dec 2018; Jan-Mar 2020; Jan-Sep 2022).*
*Source: Morningstar Direct*

## Make it Real: What Happened When Equities Were Down?

The correlations above explain why portfolios can feel diversified in calm markets but still draw down together. Figure 5 (*next page)* shows how these sleeves behaved across four recent stress windows, a more direct test of historical behavior than labels.

Across these historical stress windows, the traditional equity sleeves and the S&P 500 averaged drawdowns of roughly -22% to -27%. In contrast, trend and gold were positive on average (+7.33% and +6.60%), while equity market neutral and absolute return stayed much closer to flat (-0.44% and -3.78%). No sleeve is perfect in every regime, but combining different drivers can materially change the portfolio experience during drawdowns.

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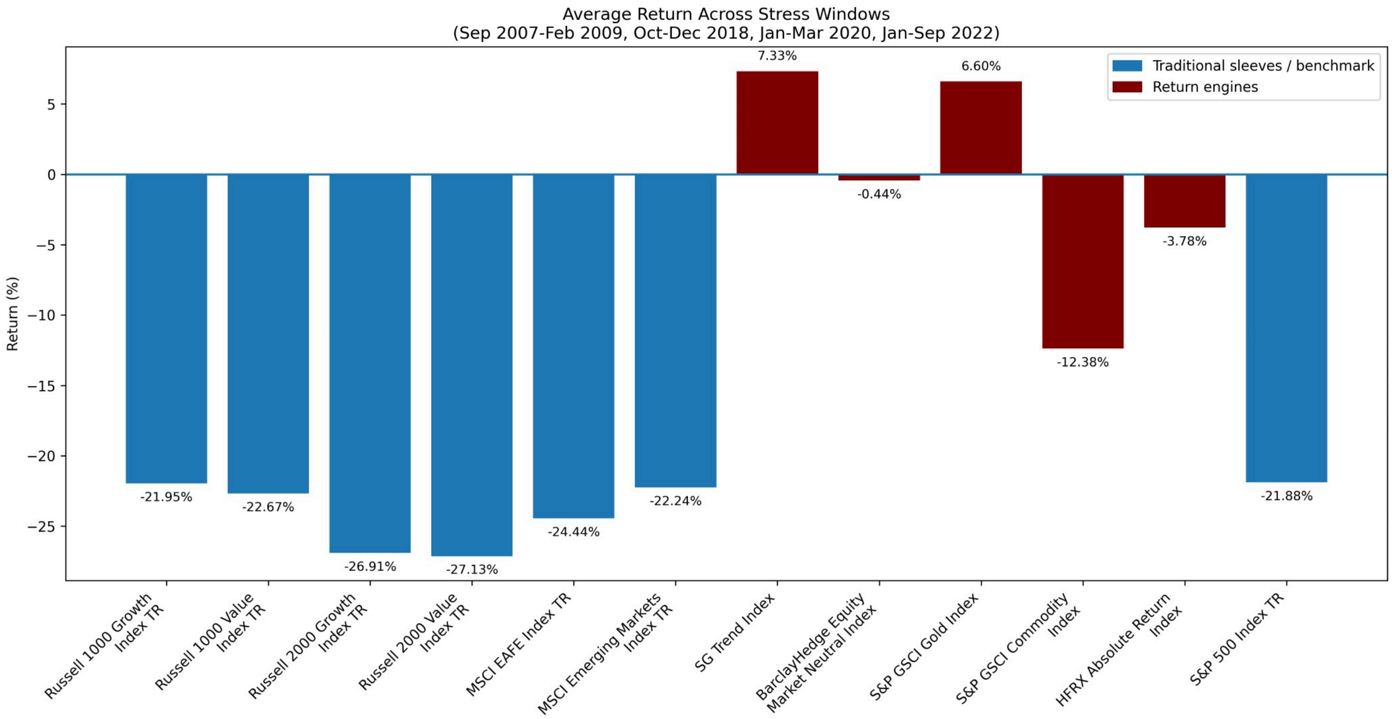


*Figure 5. Average return across stress windows (Sep 2007-Feb 2009; Oct-Dec 2018; Jan-Mar 2020; Jan-Sep 2022).*
*Source: Morningstar Direct*

## Putting Diversification to the Test

The takeaway from the figures is simple: treat diversification as something you can define, measure, and re-check, not a set-it-and-forget-it allocation. In practice, that means moving from labels to drivers, and from assumptions to repeatable tests across different market environments.

***Define the return driver -*** Start by naming the true return driver for each sleeve. What has to be true for it to work, and what conditions tend to break it? This helps anchors the portfolio in behavior and methodology rather than style-box labels.

***Measure overlap across regimes -*** Use correlations as a diagnostic, not a permanent truth. Look at relationships in normal markets and in stress windows, then revisit them over time to confirm that the mix is still behaving like multiple engines and not one crowded trade.

***Use optimization as decision support -*** Optimization can help size exposures, but it should not be the final word. Pair the math with judgment about robustness, liquidity, and implementation costs, because the portfolio has to be built for the real world, not just the backtest.

## Bottom Line

True diversification in equity portfolios is not achieved by adding style boxes; it is a portfolio with multiple, differentiated sources of return. In today's complex, interconnected markets, validating how these components behave together across various market environments, especially during stress, is more important than ever.

*Disclosures on next page*

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*Glossary:*
**BarclayHedge Equity Market Neutral Index:** Tracks hedge fund strategies designed to reduce overall stock market exposure by balancing long and short equity positions and focusing on relative performance.

**HFRX Absolute Return Index:** Represents hedge fund strategies that seek positive returns across different market environments, with an emphasis on risk management rather than tracking traditional markets.

**MSCI EAFE Index:** An international equities market index that consists of large and mid-cap stocks across developed markets in Europe, Australasia, and Far East Asia. Excludes US and Canadian equities.

**MSCI Emerging Markets Index:** An international equities market index that consists of large and mid-cap stocks across 24 emerging market countries that include, but are not limited to Brazil, Chile, China, Colombia, Czech Republic, Egypt, Greece, Hungary, India, Indonesia, South Korea, Kuwait, Malaysia, Mexico, Peru, Philippines, Poland, Qatar, Saudi Arabia, South Africa, Taiwan, Thailand, Turkey, and United Arab Emirates.

**Russell 1000 Growth TR:** Measures the performance of large U.S. companies expected to grow earnings or sales faster than the broader market, typically reinvesting profits to support expansion.

**Russell 1000 Value TR:** Tracks large U.S. companies that are considered relatively undervalued, often characterized by lower prices relative to fundamentals such as earnings or book value.

**Russell 2000 Growth TR:** Reflects the performance of smaller U.S. companies with higher expected growth potential, which may experience greater price volatility than larger firms.

**Russell 2000 Value TR:** Represents smaller U.S. companies that are viewed as undervalued, often offering higher income potential but with increased sensitivity to economic conditions.

**SG Trend Index:** Represents managed futures strategies that seek to capture sustained price trends across global markets, including equities, bonds, currencies, and commodities.

**S&P GSCI Gold Index:** Measures the performance of gold, with returns influenced by factors such as inflation expectations, currency movements, and market uncertainty.

**S&P GSCI Commodity Index:** Provides exposure to a broad basket of commodities across sectors such as energy, agriculture, and industrial metals, reflecting the performance of physical raw materials.

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