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The Diversification Illusion

Why Most Multi-Asset Funds Fall Short on True Risk Diversification

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Why Most Multi-Asset Funds Fall Short on True Risk Diversification

Multi-asset funds are viewed as investment vehicles with broad diversification, but the reality can often fall short of this expectation.

Many are structurally concentrated - relying heavily on bonds, large-cap US equities and the associated significant exposure to the US dollar. This creates a ‘diversification illusion’ that leaves portfolios more vulnerable when markets move together, highlighting the need to understand the hidden limitations of traditional multi-asset funds.

The Diversification Challenge for Traditional Multi-Asset Funds

Multi-asset funds aim to be diversified; indeed, multi-asset and diversification go hand in hand. However, while multi-asset funds may hold a wide range of securities, actual diversification depends on how these assets behave relative to one another. If the holdings are highly correlated or concentrated in investments with similar return drivers, the portfolio’s risk is not as spread out as the number of holdings might otherwise suggest.

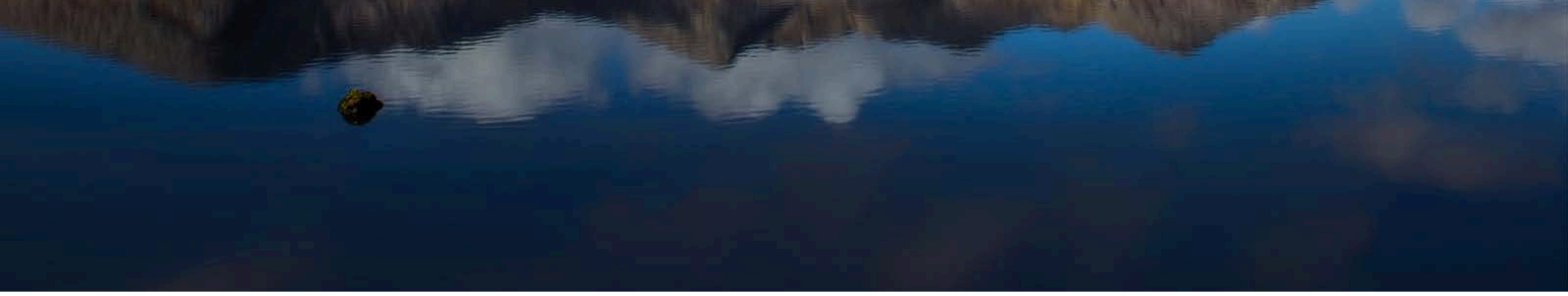
This is a feature, not a bug, of traditional multi-asset funds because less correlated asset classes and investment strategies are typically inaccessible via securities and must be sourced via specialist actively managed funds.

These funds are more expensive than direct securities or index-tracking ETFs, so cost becomes a constraint, leading to a more security and ETF-dominated portfolio construction approach. The result is less genuine diversification, as measured by investments that will deliver differentiated performance across different market environments.

This reduced diversification manifests itself in three main asset concentration issues:

- Non-equity allocation is heavily weighted towards fixed income, which relies on bonds to deliver positive returns uncorrelated to equities.
- Equity exposure is primarily dominated by passive, market-cap-weighted ETFs, with a notable concentration in large and mega-cap US stocks, and only limited allocation to active managers.
- The combined dominance of US equities and US Treasuries leads to an outsized, often unintended, exposure to the US dollar - heightening currency risk for Euro-based investors if the US dollar weakens.

There will be periods when bonds generate attractive returns uncorrelated to equities, US equities outperform other regions, and the US dollar is all-conquering. However, when this is not the prevailing environment, traditional multi-asset funds may be structurally compromised in their ability to deploy an alternative asset allocation approach.



The Perfect Storm for Multi-Asset funds

Bond & Equity Correlations

In the 40-year bull market for bonds between 1980 and 2020, government bonds consistently rose when equities fell sharply, as central banks came to the rescue by cutting rates. However, the belief that equities and bonds will move in opposite directions is not always correct. Under certain market conditions, these assets can become correlated, exposing the risks of depending too heavily on this relationship for diversification. Ironically, this breakdown in the negative correlation relationship can occur precisely when uncorrelated returns are most needed, as demonstrated a few years ago.

In 2022, bonds and equities were highly correlated, and both performed poorly, meaning that bonds provided no real protection during the equity market sell-off. In multi-asset land, this was most acutely observed by the almost identical 2022 calendar year performance of more conservatively categorised multi-asset funds with a c. 30% allocation to equities and more growth-orientated multi-asset funds with a c. 60-70% allocation to equities.

Looking ahead, if bond investors require higher yields due to rising budget deficits and persistent inflation, the historically low correlation between bonds and equities may become less dependable than it was in the past.

Over-exposure to Uncle Sam

In traditional multi-asset funds, as in global passive indices, the equity allocation is dominated by the US and, by extension, US growth stocks. Since the Great Financial Crisis (GFC), this has served multi-asset funds well, with US equity markets consistently outperforming other regions. However, this concentration in US large-cap stocks undermines the principle of diversification and creates an elevated level of correlation within the equity component of traditional multi-asset funds.

Multi-Asset Funds 2.0

How does the new iteration of multi-asset funds seek to differentiate itself from the more traditional portfolio construction approach? One fund that is adopting an alternative approach is the Key Capital Balanced Multi Strategy Fund (BMS), a sub-fund of Schroder Special Situations Fund SICAV[i], which combines Key Capital's deep understanding of the Irish private client market with Schroders's leading multi-asset expertise.

Schroders has c. €900 billion[ii] in assets under management, and this gives access to institutional-grade diversification via allocations to asset classes and investment strategies such as hedge funds, catastrophe bonds, EM debt and alternatives.

i The BMS Fund is managed by Schroder Investment Management (Europe) S.A, a member of the Schroders Group. Schroders Investment Management (Europe) S.A. is regulated by the Commission de Surveillance du Secteur Financier.
ii Source: Schroders as at 30/06/2025.

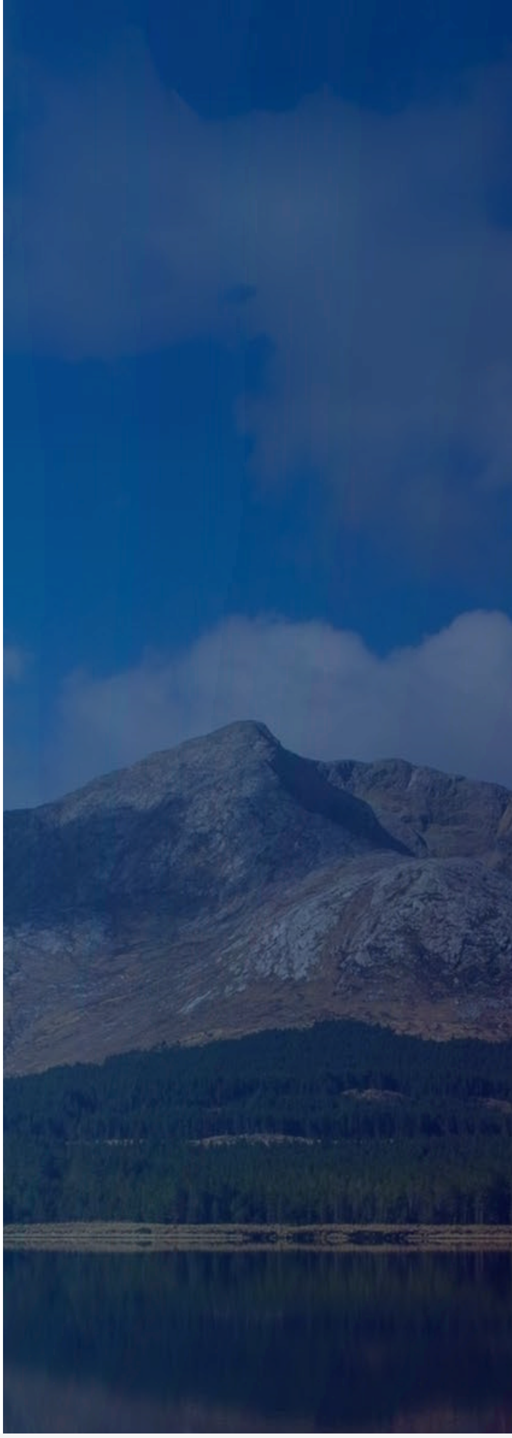
The BMS fund manager has access to c. 600 Schroders internally managed funds, which is complemented by allocating to funds managed externally to Schroders, this facilitates BMS's meaningful allocation to actively managed funds, currently c.15.

Schroders also has over 100+ years of experience managing multi-asset mandates, managing over €220 billion in global multi-asset mandates[iii]. This depth of multi-asset expertise is central to effectively managing the complexity of the new iteration of multi-asset funds. This is evident in the management of currency exposure in a fund created for Euro-based investors. BMS utilises currency forwards to ensure that exposure to non-Euro currencies is actively managed rather than a pass-through outcome of the fund's level of non-Euro assets. This approach actively manages non-Euro currency exposure, typically within a 20-40% range.

Summary

There's a strong case to rethink what true diversification means in a multi-asset fund and to build portfolios that are prepared for a wider range of outcomes. Most traditional multi-asset funds may appear to be diversified, but the actual diversification level and portfolio resilience are typically much lower. The evolution of multi-asset funds must have at their core the creation of a truly diversified portfolio through a meaningful allocation to active managers and a greater utilisation of alternative assets.

Investing is not about removing uncertainty, but rather, on managing it intelligently. In the current market, diversification is more critical than ever, and proper diversification requires allocating more broadly than US dollar-denominated market cap-weighted indices and bonds.



iii Source: Schroders as at 30/06/2025.

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