

Avoid Striking Out in 2026 with Diversification

Key Takeaways

- **Diversification is working again** as markets are less concentrated and returns are coming from more places.
- **How you diversify matters** as much as how much you diversify as assets respond differently to economic changes.
- Investors are **rewarded for building portfolios that can adapt to many outcomes** rather than betting on a single outcome.

For a few years, diversification felt broken. A small group of U.S. mega-cap growth stocks dominated returns, bonds struggled, and anything outside that narrow lane looked unnecessary.

Then markets started to see a change in 2025, and as we move into 2026, investors are asking a fair question: is diversification finally working again—and will last year's trends continue?

The answer is likely yes, but diversification in 2026 may look different from what investors grew used to over the past decade.

Why Diversification Is Making a Comeback

Diversification didn't break because it was flawed. It was challenged from a return standpoint because markets were unusually concentrated.

Ultra-low interest rates, abundant liquidity, and steady globalization rewarded a single style of investing. When inflation surged and rates rose, correlations spiked, and portfolios exposed to one narrow outcome suffered.

By 2025, the environment had shifted. Interest rates settled at higher, more normal levels. Inflation cooled but didn't disappear. Economic growth slowed but stayed resilient. Corporate earnings became more dispersed.

That's the kind of market where different investments start behaving differently again, which is exactly what diversification needs.

Diversifying Within Equities: Why It Matters Again

Equities remain the primary growth engine for long-term investors. But in 2026, how you own equities matters as much as how much.

International Equities: A Different Economic Cycle

For much of the past decade, U.S. stocks outperformed nearly everything else. That made international exposure feel unnecessary.

In 2026, the case looks stronger. Valuations outside the U.S. remain meaningfully lower, and currency movements can provide an additional return tailwind. Economic leadership is less synchronized globally, and many international markets are earlier in their rate-cutting cycles.

International stocks don't need to outperform every year to be valuable. Their role is to diversify economic and policy risk, so portfolios aren't dependent on one country's outcomes.

Dividend-Paying Stocks: Income and Discipline

Dividend strategies were often overlooked when growth stocks dominated. In a higher-rate world, they matter again as they generate a steady stream of income. Being in more mature, cash-flow-rich businesses, they tend to hold up better during periods of market volatility.

In 2026, dividends offer something investors value more than ever: a return that doesn't depend entirely on rising stock prices.

Small-Cap Stocks: Sensitivity to Growth and Rates

Small-cap stocks have lagged large caps for much of the last decade. That underperformance has left them historically inexpensive relative to large caps, more sensitive to economic acceleration, and more responsive to stable or falling interest rates.

They don't lead in every market—but when growth broadens, and financing conditions improve, small caps can add meaningful diversification and upside to equity allocations.

Value and Quality: A Counterbalance to Concentration

The concentration of equity returns in a handful of large growth companies has begun to unwind. Value- and quality-oriented stocks are often tied to real economic activity and benefit from pricing power and balance-sheet strength. They provide diversification when leadership rotates.

Bonds and Alternatives: Supporting Cast, Not Side Notes

While equities drive long-term growth, bonds and alternatives are once again doing their jobs. Bonds are producing income and stabilizing portfolios while real assets, including gold and silver, and alternatives help manage inflation and volatility, especially since they don't rely on earnings or interest rates.

This combination supports equities during drawdowns—and helps investors stay invested.

Asset Class Returns Experience Changing Leadership While Diversification Provides Smoother Ride

| 2016 | 2017 | 2018 | 2019 | 2020 | 2021 | 2022 | 2023 | 2024 | 2025 | YTD | KEY: |
|------|------|-------|------|------|------|-------|------|------|------|-----|-----------------------|
| 22.5 | 37.8 | 0.0 | 31.5 | 18.7 | 28.7 | -11.2 | 26.3 | 25.0 | 34.4 | 8.9 | US Equities |
| 17.1 | 25.6 | -2.1 | 25.1 | 18.4 | 25.3 | -13.0 | 18.9 | 12.3 | 31.9 | 5.2 | US Small/Mid Cap |
| 12.0 | 21.8 | -2.1 | 22.7 | 14.4 | 11.8 | -14.0 | 16.3 | 9.8 | 17.9 | 4.5 | International Eq |
| 11.6 | 17.5 | -2.5 | 18.9 | 13.0 | 9.1 | -14.0 | 15.8 | 8.2 | 16.9 | 2.4 | Emerging Market Eq |
| 9.9 | 15.3 | -4.4 | 18.9 | 10.1 | 5.3 | -15.3 | 13.4 | 8.1 | 11.1 | 1.6 | US Bonds |
| 6.1 | 10.5 | -5.7 | 14.3 | 8.3 | -1.5 | -17.1 | 10.3 | 6.6 | 8.9 | 1.5 | US High Yield |
| 2.6 | 8.2 | -10.3 | 13.1 | 7.5 | -1.7 | -18.1 | 9.1 | 4.3 | 8.6 | 0.5 | International Bonds |
| 1.5 | 7.5 | -13.4 | 8.7 | 7.1 | -2.2 | -18.7 | 5.6 | 1.3 | 7.3 | 0.4 | Emerging Market Bonds |
| 1.5 | 3.5 | -14.2 | 5.1 | 6.5 | -7.0 | -19.7 | 5.5 | -4.2 | 7.0 | 0.1 | Global 60/40 |

Source: Zephyr Style Advisor. Asset classes represented by S&P, MSCI, or Bloomberg indices. Returns as of January 30, 2026.

Will 2025's Trends Continue into 2026?

While still early in the year, the trends we saw in 2025 are continuing into 2026, with the addition of smaller caps now coming to the forefront, as seen in the chart below. 2026 is shaping up to be a market that rewards

- Balance over concentration
- Income alongside growth
- Regional and style diversification
- Patience over precision

The days of one asset or one strategy carrying portfolios may be behind us.

Avoid Striking Out

Diversification is finally working again—not because markets are easier, but because they're more honest.

That doesn't mean giving up on growth. It means pursuing growth without putting all your eggs in one basket—even when that basket has worked for a long time.

Trying to time the turning point in the boom-to-bust cycle is extremely hard, but that's why diversification is key, as you don't have to determine the winners in advance. There will be parts of the portfolio that outperform, and parts that underperform, but over the long term, you'll have a portfolio that can adapt to the changing market whims.

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