

Why Does Diversification Matter Now More Than Ever?



Key Takeaways

The market for alternative assets has evolved from a once-exclusive niche into a critical pillar of modern portfolio construction. Today's highly valued stock market, relatively low fixed income yields, elevated inflation, and increasing correlation between stocks and bonds have driven demand for new sources of performance and risk management. However, if you are seeking diversification in your portfolio, it is important to understand that not all "alternative investments" are the same and why.

Why 60/40 May No Longer Be Enough

As markets evolve, so must investment strategies. An approach that made sense years ago may no longer be effective in today's macroeconomic environment. That's why investors need to reassess portfolio frameworks as conditions change.

The concept of the 60/40 portfolio, comprised of equities and fixed income, emerged in the 1950s as a model for constructing diversified portfolios, balancing growth and defense through asset allocation. Historically, stocks provided growth while fixed income balanced against volatility. The catch: The 60/40 model only works when stock and bond markets are *uncorrelated*, meaning their prices move differently in response to changes in the economy.

Decades ago, investors had few options beyond stocks and bonds when building diversified portfolios. Today, the investment landscape has changed. Investments that were once only accessible by institutions and high-net-worth investors are now available to the general public in lower minimum, liquid structures, such as mutual funds and ETFs. As a result, a broader range of investors can now achieve differentiated return streams that may help improve diversification, manage risk, and complement traditional asset classes.

In 2022, both stocks and bonds declined simultaneously, catching many investors by surprise. This signaled what may be a lasting structural shift in asset class behavior, driven by persistent inflation, elevated equity valuations, and long-term fiscal pressures.

- **The 60/40 portfolio is no longer sufficient** in today's market environment, where stock and bond correlations have increased, especially during periods of elevated inflation and structural macroeconomic shifts.
- **Effective diversification requires incorporating low-correlating strategies** that behave differently from equities and fixed income, particularly in inflationary regimes.
- **Not all alternative investments offer real diversification.** The key is to identify strategies with low or negative correlations to traditional asset classes to reduce portfolio risk and enhance resilience.

Correlation

(kôr'ə-lā'shən)

The tendency for two values or variables to change together, in either the same or opposite way.

The American Heritage® Dictionary of the English Language, 5th Edition.

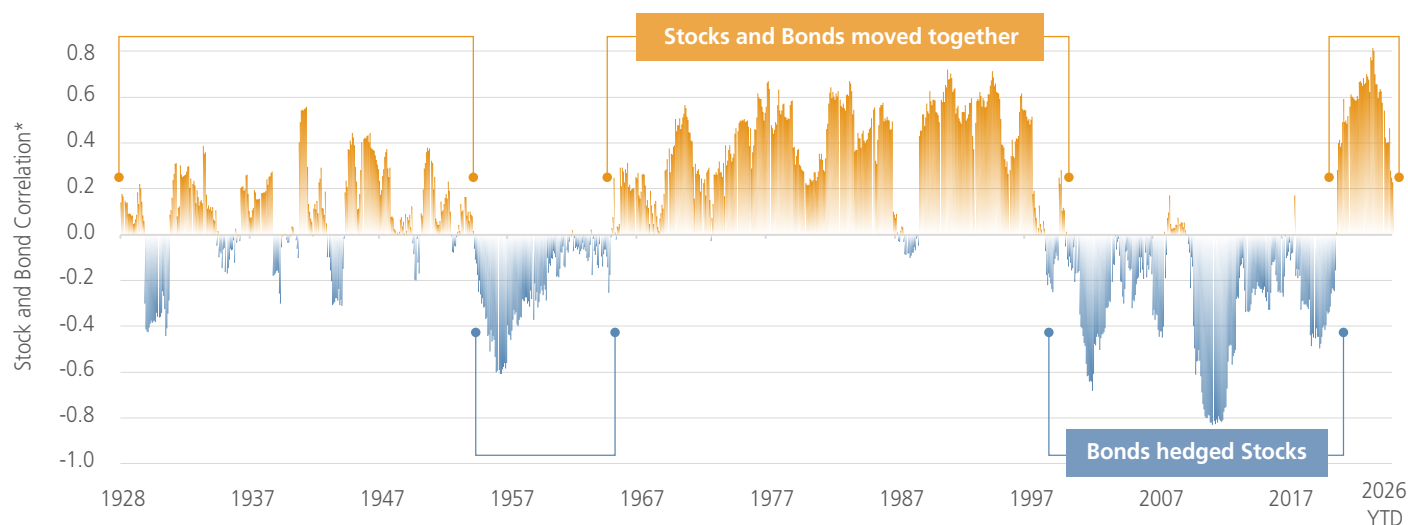
Why Inflation Matters

The shift toward higher inflation that followed the pandemic came after two decades of unusually benign price growth. When inflation is low, fixed income tends to move independently of equities and therefore, works well as a defensive strategy for portfolios. In early 2022, however, pent-up demand and supply constraints following the COVID-19 pandemic drove prices higher. This ushered in a new era of persistent inflation¹ that remains today amid deglobalization, policy uncertainty around trade and tariffs, as well as heightened geopolitical risk and increased awareness due to recent conflicts.

The chart below illustrates how inflationary regimes (the orange sections) can persist for several decades. This is because the factors that cause inflation, such as wage growth, supply constraints, and policy responses, tend to become embedded in an economy. Against this backdrop, inflation-driven market conditions may persist longer than expected, requiring a more durable approach to portfolio construction.

Correlation of Stocks and Bonds During Inflationary Regimes - January 1928 - June 2026

When inflation is elevated, equity and fixed income markets tend to be positively correlated.



Source: LoCorr Fund Management and Morningstar Direct. Monthly data as of June 2026. *Average 2-yr rolling correlation between IA SBBI U.S. Large Stock TR Index and IA SBBI U.S. Long-Term Government TR Index, which transitioned to the Bloomberg U.S. Government Long Index on 12/31/1975.

Past performance is not a guarantee of future results.

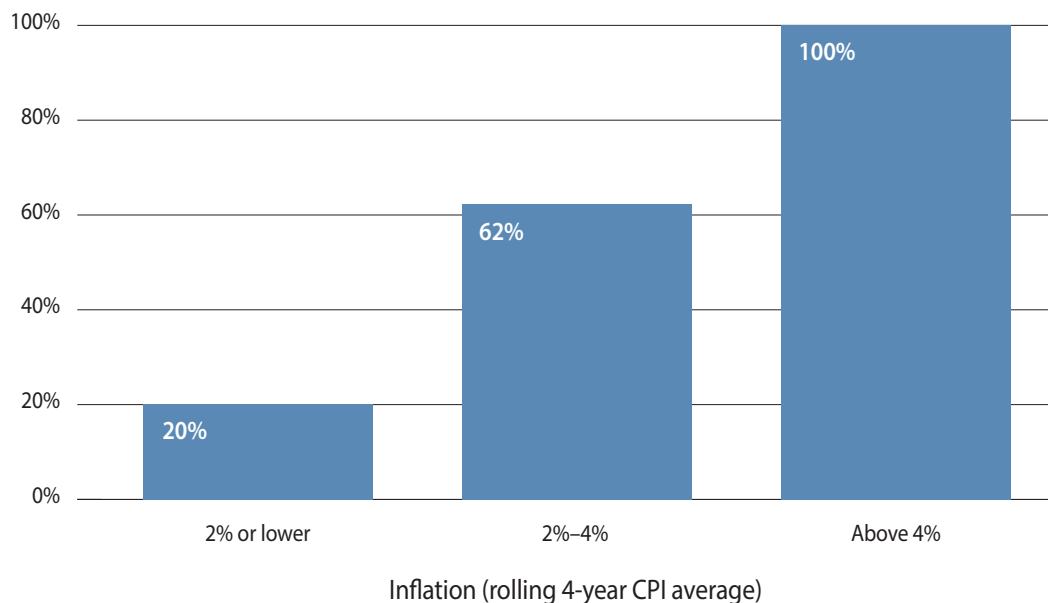
How Can Inflation Lead to Positive Correlations?²

- Rising inflation may cause central banks to increase short-term interest rates. Bond prices fall as yields increase.
- A higher discount rate reduces the present value of companies' future earnings, potentially causing stock prices to decline.
- Equity markets may fall due to expectations for a slowdown in economic activity.
- Expectations for possible future interest rate increases (to battle inflation) could lead to increasing bond risk premiums, putting additional downward pressure on bond prices.

As the level of inflation increases, stocks and bonds have tended to move together, as shown below, undermining the diversification benefit of fixed income as a risk management tool. This makes it essential to explore asset classes that may behave differently from both equities and fixed income in inflationary environments. (These asset classes were not available to retail investors, or financial advisors, in the past when the 60/40 framework was established.)

Elevated Inflation Has Historically Meant Greater Correlation – January 1986 - June 2026

While inflation remains elevated, traditional diversification breaks down, limiting risk management options unless investors incorporate low-correlated strategies into portfolios.



Source: Morningstar Direct.
Time period 1/1/86-6/30/26.
Stocks represented by
S&P 500 Index and bonds
represented by Bloomberg
U.S. Aggregate Bond Index.
**Past performance is not a
guarantee of future results.**

➤ Adding a third asset class beyond equities and fixed income to create a 60/20/20 or 50/30/20 portfolio may strengthen diversification, making the portfolio resilient to a broader set of economic circumstances.

Correlation Matters—Here's Why

Not all alternatives are created equal. The fact is that many types of alternatives are highly correlated with equities and fixed income and therefore offer little safeguard from volatility. The table below shows that of Morningstar's five most popular alternative categories, four had correlations to equities of 0.81 or greater in 2022, meaning they moved in the same direction as the overall market. The notable exception was the Systematic Trend category, which featured a low-to-negative correlation to stocks and bonds. The key to effective portfolio construction is to identify and combine strategies that behave distinctly.

Not Every Alternative Helps Manage Risk

Of Morningstar's top five alternative categories, four were highly correlated with equity markets.

Morningstar Category Average	Returns 1/1/22-12/31/22	Correlation** to S&P 500 Index
Equity Hedged***	-9.55%	0.92
Multistrategy	-3.00%	0.90
Relative Value Arbitrage	-3.86%	0.81
Event Driven	-1.32%	0.85
Systematic Trend	14.53%	-0.10

Source: Morningstar Direct. **Since common inception 4/1/07-12/31/22. ***Formerly the Morningstar Options Trading Category.

Returns are annualized for periods greater than one year. Performance data quoted represents past performance; **Past performance does not guarantee future results.**

Correlation ranges on a scale from 1 (perfectly correlated) to -1 (inversely correlated). For investors whose primary objective is diversification, an optimal correlation value might range between -0.5 to 0.5. Anything below -0.5 has a high inverse correlation, and anything above 0.5 could move too closely in tandem with equity markets. The objective of diversification is to find strategies that move independently, but not necessarily inversely.

Conclusion

The potential for inflation shocks remains higher than markets have been accustomed to. Rather than returning to the low and stable inflation environment that characterized much of the pre-pandemic era, the global economy appears increasingly susceptible to inflation volatility driven by supply chain disruptions, geopolitical tensions, structural labor shortages, and more expansionary fiscal policy. Building portfolios with strategies that can adapt to changing inflation regimes may help improve resilience when traditional diversification falls short.

With low-correlating strategies, the benefits of diversification are grounded in mathematics. Combining investments with low correlations may reduce overall portfolio risk, while improving the potential for more consistent risk-adjusted returns. The key is identifying truly differentiated sources of return, which begins with understanding how investments behave relative to one another. Fortunately, investors today have access to a broader range of investment strategies than ever before, making it easier to incorporate differentiated sources of return into traditional portfolios.

Diversification through low-correlated alternatives is not a trend but rather reflects an evolution of portfolio construction. The traditional stock-bond relationship has become less reliable, with stocks and bonds recently moving more or less in the same direction and bond yields remaining below historic averages. This environment underscores the need for investors to look beyond traditional markets for asset classes with low correlations to core investments and the potential to generate growth. Getting the allocation decision right may lead to improved stability and better risk-adjusted returns. In doing so, investors can position their portfolios for greater resilience and a higher likelihood of helping them achieve their long-term financial goals.



“Searching for alpha and income diversification among strategies that remain highly correlated to stocks and bonds is not likely to be a winning strategy. Instead, consider low-correlating strategies that can potentially achieve both goals while also reducing overall portfolio risk.”

– Sean Katof, CFA®, CAIA®
Chief Investment Officer, LoCorr

About LoCorr

LoCorr is a leading provider of low-correlating investment strategies founded on the belief that non-traditional investment strategies with low correlation to stocks and bonds can reduce risk and help increase portfolio returns. LoCorr offers investment solutions that provide the potential for positive returns in rising or falling markets and help to achieve diversification in investment portfolios.

Contact your financial advisor to learn more.

LoCorr | 888-628-2887 | info@locorrfunds.com

¹Russell Investments, "Alternative Diversifiers: Rethinking Diversification in Investment Portfolios" (2024), accessed March 17, 2025, <https://russellinvestments.com/content/ri/us/en/insights/russell-research/2024/09/alternative-diversifiers-rethinking-diversification-in-investmen.html> ²Boyu Wu, Beatrice Yeo, Kevin DiCiurcio, and Qian Wang. 2021. "The Stock/Bond Correlation: Increasing amid Inflation, but Not a Regime Change." Vanguard Research, September.

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S&P 500 Index is a capitalization weighted unmanaged benchmark index that includes the stocks of 500 large capitalization companies in major industries. This total return index includes net dividends and is calculated by adding an indexed dividend return to the index price change for a given period. **Bloomberg U.S. Aggregate Bond Index** is a broad-based bond index comprised of government, corporate, mortgage and asset-back issues rated investment grade or higher. **IA SBBI U.S. Long-Term Government TR Index** measures the performance of a single issue of outstanding U.S. Treasury bond with a maturity term of around 21.5 years. It is calculated by Morningstar and the raw data is from Wall Street Journal. **IA SBBI U.S. Large Stock TR Index** tracks the monthly return of S&P 500 Index. The history data from 1926 to 1969 is calculated by Ibbotson. **Bloomberg US Government: Long Index** is a market capitalization-weighted index tracking USD-denominated, fixed-rate, nominal US Treasury and agency debentures with maturities of 10 years or more. It represents the long-term, investment-grade portion of the US government bond market, excluding STRIPS, with history dating back to 1973. **Morningstar Equity Hedged Category** identifies funds that provide hedged equity exposure using options and other derivatives. These funds employ tactics like covered calls, put writing, and collars to generate income, reduce volatility, and alter investment risk profiles. **Morningstar Multistrategy Category** describes funds that invest in two or more alternative investment strategies. These funds combine methods like event-driven trading, options, and market-neutral strategies using a single or multiple managers. They aim to achieve low sensitivity to traditional stock and bond markets. **Morningstar Relative Value Arbitrage Category** identifies funds that seek to profit from pricing differences between pairs or combinations of related securities. Managers buy the underpriced asset and sell the overpriced asset to capture the difference. These funds use strategies like convertible arbitrage and fixed-income arbitrage across various asset classes. **Morningstar Event Driven Category** consists of funds that seek to profit from price changes caused by major corporate events. These events include mergers, acquisitions, bankruptcies, and corporate restructurings. Managers in this group typically look for short-term opportunities rather than long-term market trends. **Morningstar Systematic Trend Category** is an average monthly return of all funds in the Morningstar Systematic Trend Category. These funds typically take long and short positions in futures options, swaps, and foreign exchange contracts, both listed and over-the-counter, based on market trends or momentum. A majority of these funds follow trend-following, price-momentum strategies.

The Fund's investment objectives, risks, charges, and expenses must be considered carefully before investing. The [prospectus](#) contains this and other important information about the investment company, and it may be obtained by calling 1.855.LCFUNDS, or visiting www.LoCorrFunds.com. Read it carefully before investing.

Mutual fund investing involves risk. Principal loss is possible. The Funds invests in foreign investments which involve greater volatility and political, economic and currency risks and differences in accounting methods. These risks are greater for emerging markets. Investing in commodities may subject the Funds to greater risks and volatility as commodity prices may be influenced by a variety of factors including unfavorable weather, environmental factors, and changes in government regulations. Investments in debt securities typically decrease in value when interest rates rise. This risk is usually greater for longer-term debt securities. Investments in Asset-Backed, Mortgage-Backed, and Collateralized Mortgage-Backed Securities include additional risks that investors should be aware of such as credit risk, prepayment risk, possible illiquidity and default, as well as increased susceptibility to adverse economic developments. Derivative contracts ordinarily have leverage inherent in their terms which can magnify the Fund's potential for gains or losses through increased long and short position exposure. The Funds may access derivatives via a swap agreement. A risk of a swap agreement is the risk that the counterparty to the agreement will default on its obligation to pay the Funds. The Funds will incur a loss as a result of a short position if the price of the short position instrument increases in value between the date of the short position sale and the date on which an offsetting position is purchased. Investments in lower-rated and nonrated securities presents a greater risk of loss to principal and interest than higher rated securities. Underlying Funds are subject to management and other expenses, which will be indirectly paid by the Funds. The Fund's portfolio will be significantly impacted by the performance of the real estate market generally, and the Funds may be exposed to greater risk and experience higher volatility than would a more economically diversified portfolio. Small and mid-sized companies may have limited product lines, markets or financial resources, and they may be dependent on a limited management group. There is no assurance that any hedging strategies utilized by the Funds will successfully provide a hedge to the portfolio's holdings which could negatively impact Fund performance.

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LC 7824 (7/26)