

CIO View Special

10 themes for the year ahead

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Marketing material



Diversification today

Planning scenarios, managing risks and seizing opportunities

There are many reasons now to pay more attention to diversification in asset allocation – and to redefine it. While the current market environment appears constructive, increased risks mean it is important to plan scenarios and identify diversification opportunities that may be path-dependent rather than universal.

Overall, the capital markets appear relatively stable: Goldilocks is still in place. And there are many indications that this environment could continue into the new year. Most central banks currently remain supportive, and the global economy is showing signs of acceleration. In such an environment, risk assets might be boosted once again.

However, despite the current positive outlook, the environment is by no means free of risks. A second wave of inflation or a global recession caused by tariffs remain potential risks. In the case of equities, valuations in individual segments appear high but not yet irrational in our view. Provided earnings and investments remain supportive and structural drivers such as artificial intelligence (AI) remain intact, there may still be room for the market to rise, even if tail risks are increasing. Uncertainties about U.S. tariff policy, the independence of the U.S. Federal Reserve and political instability in Europe could trigger volatility. Risk compensation appears low for corporate bonds, while valuation and liquidity risks could become more apparent in private markets.

Therefore, diversification is more important than ever. Traditional diversification across regions and asset classes alone may no longer be enough. Today, diversification should be considered in terms of scenarios. Which investments might mitigate downside risk in a portfolio if a stock market bubble were to burst? Which investments could help if inflation proved surprisingly strong or doubts about countries' debt sustainability deepened? "Not every diversifier works in the same way in every scenario," explains Peter Warken, Co-Head of Allocation at DWS. "The key is to build a robust portfolio and have a plan for different scenarios."

European small caps, for instance, may help mitigate equity concentration risks and could benefit from the German infrastructure program and improved growth in the

Eurozone. For diversification via structural alpha themes, focusing on infrastructure, cheaper AI names accessed via Asian tech stocks and reviving European assets could be promising. In corporate bonds, the robust fundamentals of EUR investment grade relative to U.S. counterparts appear favorable for European investors, who also benefit from the absence of currency hedging costs, whereas U.S. investors should account for potential currency risk and associated hedging expenses.

Diversification is key



*Based on DWS Long View¹; Sources: Bloomberg Finance L.P., DWS Investment GmbH as of 9/30/25

Gold seems to remain an effective diversifier but is not a panacea. It may be particularly effective for those concerned about high government debt and political uncertainty, and keen to shift away from U.S. assets. But caution is advised in the short term given the degree to which the gold price has risen, notwithstanding its recent small correction. In the event of a stock market crash, government bonds might offer better initial risk management as gold might initially sell off. The dollar, on the other hand, has seemingly lost its classic diversification role for the time being.

We think that there is a good chance that the Goldilocks phase will continue into 2026, which could favor equities and high-quality corporate bonds, supplemented by a scenario-based diversification strategy. Peter Warken summarizes, "Those who consistently follow this diversification principle may create stability and potentially also open up opportunities in a complex market environment."

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Footnotes

¹ World equities based on MSCI AC World Index; U.S. equities based on MSCI USA Index; Germany equities based on MSCI Germany Index; Europe equities based on MSCI Europe Index; Asia ex Japan equities based on MSCI AC Asia Pacific Excluding Japan Index; EUR Treasury based on Bloomberg Euro Treasury Index; EUR Corporate based on Bloomberg Euro Aggregate Corporate Index; Euro High Yield based on Bloomberg Pan-European High Yield (Euro) Index; US Treasury based on Bloomberg US Treasury Index; US Corporate based on Bloomberg US Corporate Index; US High Yield based on Bloomberg US Corporate High Yield Bond Index.

Glossary

Alpha refers to returns in excess of a benchmark's return.

Artificial intelligence is the theory and development of computer systems able to perform tasks normally requiring human intelligence

Asset allocation is the division of investments into individual asset classes (e.g. stocks and bonds).

The **Bloomberg Euro-Aggregate Treasury Index** is a benchmark that measures the Treasury component of the Euro-Aggregate. The index consists of euro-denominated, fixed-rate, investment grade public obligations from member states of the European Union.

The **Bloomberg Euro High Yield Index** measures the market of non-investment grade, fixed-rate corporate bonds denominated in Euro. Inclusion is based on the currency of issue, and not the domicile of the issuer.

The **Bloomberg Euro-Aggregate Corporates Index** is a benchmark that measures the corporate component of the Euro Aggregate Index. It includes investment grade, euro-denominated, fixed-rate securities.

The **Bloomberg US Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market.

The **Bloomberg US Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below.

The **Bloomberg US Treasury Index** measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury.

A **bubble** is characterized by prices surging higher than warranted by fundamentals, followed by a drastic drop in prices as a massive sell-off occurs.

A **central bank** manages a state's currency, money supply and interest rates.

Portfolio **concentration** measures single stock exposures of a portfolio.

A **corporate bond** is a bond issued by a corporation in order to finance their business.

Diversification refers to the dispersal of investments across asset types, geographies and so on with the aim of reducing risk or boosting risk-adjusted returns.

The term **Goldilocks economy** refers to a state of the economy, where there is neither a threat of inflation due to an overheating economy, nor a threat of a recession.

Hedging costs are similar to an insurance premium paid for not being exposed to price movements of certain financial assets. The premium paid for an option is a typical cost of hedging.

High-yield bonds are issued by below-investment-grade-rated issuers and usually offer a relatively high yield.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Investment grade (IG) refers to a credit rating from a rating agency that indicates that a bond has a relatively low risk of default.

Liquidity refers to the degree to which an asset or security can be bought or sold in the market without affecting the asset's price and to the ability to convert an asset to cash quickly.

The **MSCI AC World Index** captures large- and mid-cap companies across 23 developed- and 24 emerging-market countries.

The **MSCI AC Asia ex Japan Index** captures large- and mid-cap representation across 2 of 3 developed-market countries (excluding Japan) and 8 emerging-market countries in Asia.

The **MSCI Europe Index** is designed to measure the performance of the large- and mid-cap segments of 15 developed markets in Europe.

The **MSCI Germany Index** tracks the performance of German stocks.

The **MSCI USA Index** is designed to measure the performance of the large- and mid-cap segments of the U.S. market.

A **recession** is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

Small cap firms generally have a market capitalization of less than \$2 billion.

The **U.S. Federal Reserve**, often referred to as "**the Fed**," is the central bank of the United States.

Valuation attempts to quantify the attractiveness of an asset, for example through looking at a firm's stock price in relation to its earnings.

Volatility is the degree of variation of a trading-price series over time. It can be used as a measure of an asset's risk.

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