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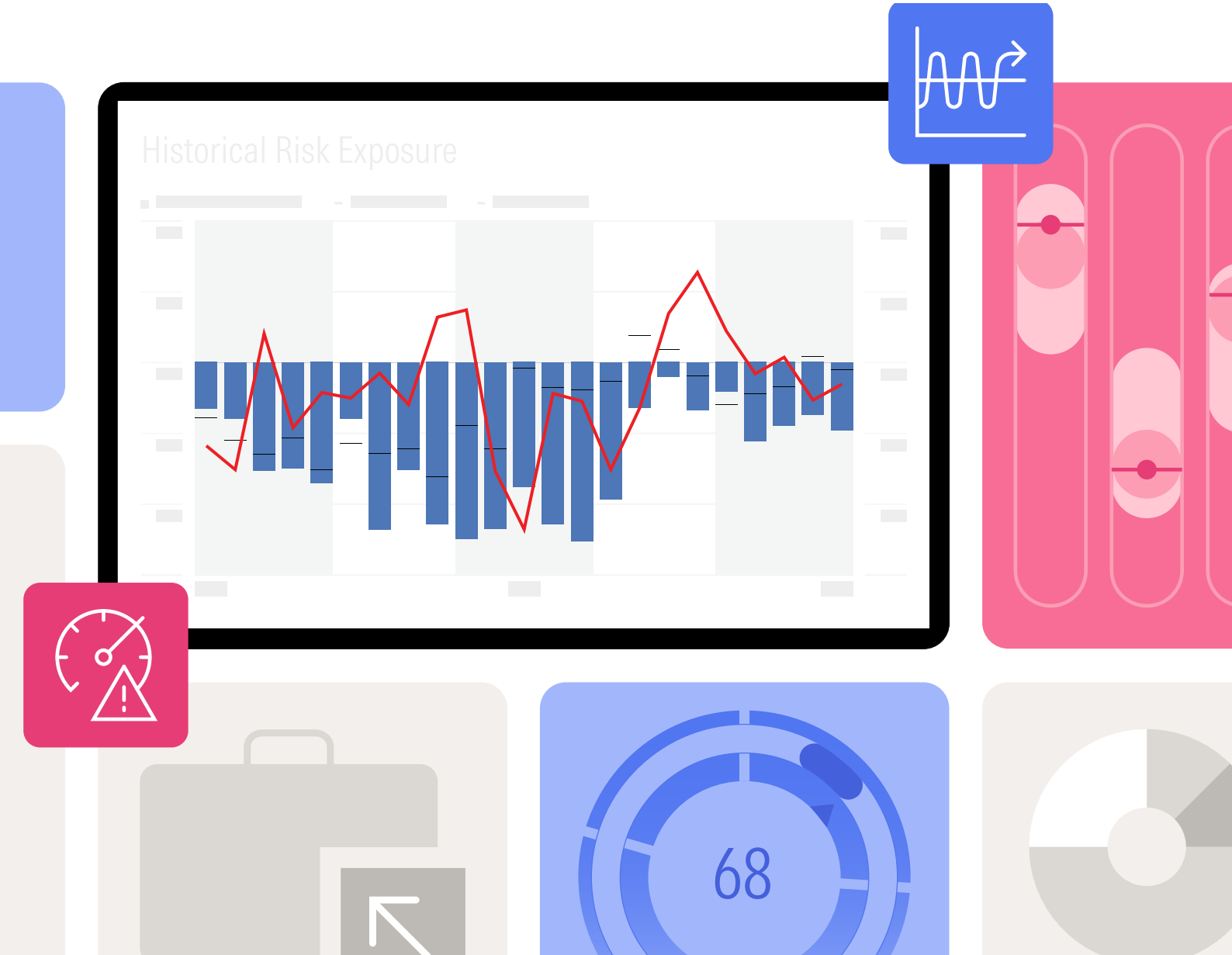
Morningstar's Guide to Risk Management in 2025



Managing Risk In a Complex Market

Risk management is a constantly evolving equation with which investment teams must keep up. The fundamental practice underpins their success and sustainability. It's essential to preserve capital, maximize returns, ensure regulatory compliance, build client trust, maintain operational efficiency, and handle market volatility.

In 2025, market volatility is more of a reality than a risk. Recent US tariff announcements and pauses caused stocks to yoyo. Fluctuations in inflation rates have caused uncertainty in the market and changes in Federal Reserve policies and interest rate adjustments have contributed to market swings. Tack on the ongoing geopolitical tensions, including conflicts in Eastern Europe and trade disputes, and the variability in oil and gas prices due to those geopolitical factors, and you've got a complex risk management landscape to navigate.

This guide will discuss some of the sources of risk, the metrics used to measure it, and the strategies deployed to mitigate it.

What's Inside:

- An overview of risk metrics and modeling
- Identifying and analyzing volatility
- Diversification and strategic asset allocation strategies
- The role of high-quality data in risk management
- How Morningstar can help empower confident and proactive risk management

Risk Metrics and Modeling

For today's investment teams, risk metrics and modeling go beyond basic exposure analysis—they're integral to navigating increasingly complex markets and client expectations. Sophisticated teams are using these tools not just to identify and quantify risks like volatility, credit events, or liquidity constraints, but to connect them directly to portfolio construction decisions and strategy refinement.

Modern risk modeling enables scenario analysis that reflects real-world market stresses and shifts in macro condition. This level of insight empowers teams to anticipate outcomes, sharpen their investment theses, and communicate risk-return trade-offs more transparently. In an environment where both performance and risk oversight are under constant scrutiny, having agile, data-driven risk frameworks is a strategic advantage.

Navigating the Nuances of Volatility and Risk Metrics

While volatility remains a widely cited proxy for risk, its limitations are well known. First among them is the inability to distinguish between upside and downside movement. For investment teams aiming to align risk assessments more closely with portfolio objectives, supplementing traditional metrics with more targeted measures is essential.

Standard deviation and beta offer a foundational view, but their utility depends heavily on context. For example, in environments with asymmetric return distributions, the Sortino Ratio often provides a more meaningful lens by isolating downside deviation. Similarly, the Downside Capture Ratio has become increasingly relevant for teams focused on capital preservation during drawdowns—highlighting how portfolios behave when benchmarks falter.

Modern portfolio construction calls for a toolkit that moves beyond a one-size-fits-all approach. Risk-adjusted return metrics like Sharpe and Sortino remain central, but are most powerful when used alongside scenario analysis, stress testing, and qualitative risk overlays. The key for investment teams is not just selecting the right metrics—but interpreting them through the lens of client goals, mandates, and market context.

Volatility can be combated by foundational risk management strategies like diversification and strategic asset allocation. Constructing portfolios that span various asset classes, sectors, and geographic regions can reduce concentration risk. Minimizing reliance on the performance of any single asset or market segment helps smooth overall returns and shield the portfolio from idiosyncratic shocks. A rigorous allocation strategy allows investment teams to align portfolio objectives with market conditions while ensuring a disciplined approach to risk and reward over time. While no framework eliminates all risk, these methodologies ensure a proactive and measured approach to portfolio management, enhancing stability and optimizing long-term value creation for clients or stakeholders.

How High-Quality Data Supports Risk Management

Let's review some case studies in diversification and asset allocation to explore the role they play in risk management and highlight the importance of high-quality data in achieving both.

Exploring the Data Behind Portfolio Diversification Strategies

Unfortunately for investors, portfolio diversification didn't boost returns in 2023's generally bullish market environment. As US stocks bounced back from their losses, most other asset classes fell behind. Most international stock benchmarks have been closely tied to the US market over the past three years. Developed-markets equities, especially European stocks, have had the tightest correlation with US equities and therefore behaved similarly. For the sake of simplicity, we'll focus on the US market in this section.

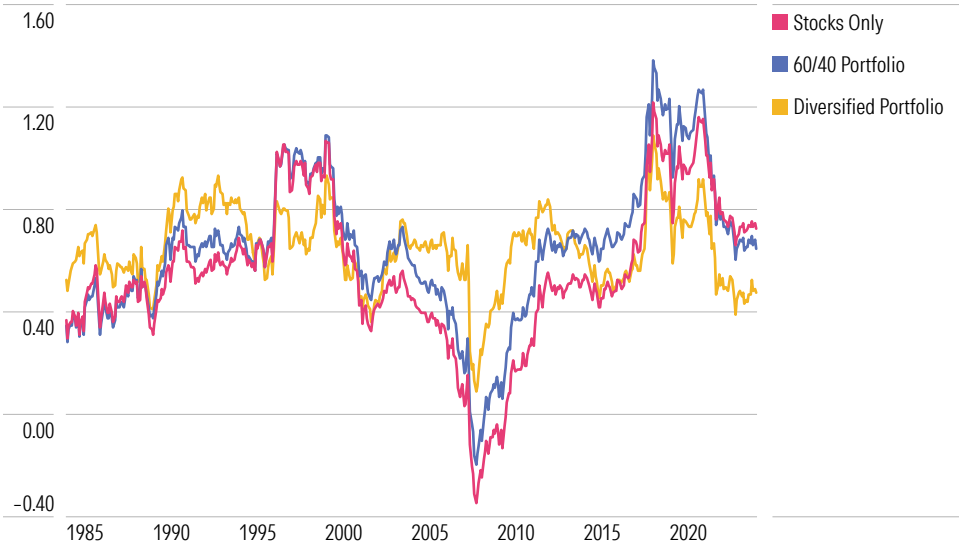
In 2022, when diversification was a net positive, every "diversified" asset class fell behind the Morningstar US Market Index in 2023. As a result, the most basic version of a 60/40 portfolio (made up of US stocks and US investment-grade bonds) gained about 18% for the year, but a more diversified version fell roughly 4 percentage points behind.

Thanks to slightly lower correlations for many of the "diversified" asset classes, the diversified portfolio would have done a better job reducing risk, but not enough to result in higher risk-adjusted returns.

More-diversified portfolio strategies have also struggled over longer periods, at least over the past two decades. The diversified portfolio reduced risk compared with a plain-vanilla mix of US stocks and bonds over most trailing periods but not enough to result in better risk-adjusted returns, as measured by the Sharpe ratio.

To test the value of diversification over longer periods of time, we can look at a US Large Stock Index and a US Intermediate Term Government Index as a baseline for a basic 60/40 portfolio.

Net Effect on Risk-Adjusted Returns (Sharpe Ratio)



Source: Morningstar Direct. Data as of December 31, 2023. The rolling 10-year Sharpe Ratios are for stocks only, 60/40 portfolio, and a fully diversified portfolio. Both portfolios assume annual rebalancing.

Although a broadly diversified portfolio improved risk-adjusted returns (as measured by the Sharpe ratio) versus an all-stock portfolio during most rolling 10-year periods between May 1993 and December 2016, Morningstar's test portfolio posted weaker risk-adjusted returns over most periods since then. The basic 60/40 portfolio, on the other hand, fared better than the stocks-only benchmark about 87% of the time going back to 1976 and came out ahead of the more broadly diversified version in every rolling 10-year period since the period starting in late 2004.

Diversifying Away: Some European Investors Avoid US Mega-Caps

Rising concentration has become one of the defining features of modern equity markets over the past decade. Concentration is when a single security or sector, like technology, makes up a significant portion of a portfolio. The "Magnificent Seven" technology stocks, which include Alphabet (Google), Amazon, Apple, Meta Platforms, Microsoft, Nvidia, and Tesla have performed so well over the past decade that they've garnered a ton of investment and therefore increased their concentration in many portfolios. Some European investors with a lot of exposure to US tech stocks want to decrease that concentration. There's at least a few ways to do it, including:

- Selecting an equally weighted index-tracking passive fund that deliberately ignores the market's consensus opinion on the relative value of each firm. By assigning equal weight to all stocks, you reduce the influence of the largest companies and increase the impact of smaller companies on returns versus standard market cap indexes.

- Selecting a fund that excludes mega caps, while allowing the remaining index constituents to be weighted by market capitalization.

- Selecting a fund that focuses on mid-cap stocks, which is a more drastic way to diversify away from mega- and large-cap stocks.

Private Equity is Booming: So Is Liquidity Risk

Wealth and asset managers are increasingly looking to private markets for diversification opportunities. By June 2024, private markets had grown to over $15.5 trillion in assets. This is accelerating demand for alternative assets, including those with semi-liquid fund structures like interval funds and real estate investment trusts. These types of investments carry more liquidity risk than their public market counterparts. Depending on structure, it might not be possible to buy or sell the asset exactly when desired. Therefore, it's imperative managers do their due diligence, which requires access to high-quality private equity data and transparency of portfolio exposure.

No one specific metric is sufficient in measuring liquidity risk. The primary dimensions of liquidity are size, time, cost, and resiliency. To assess a portfolio's liquidity, investors should use a mosaic of metrics for each liquidity dimension and look at a fund from the perspective of its investment process relative to its investment universe and not its broadly defined market.

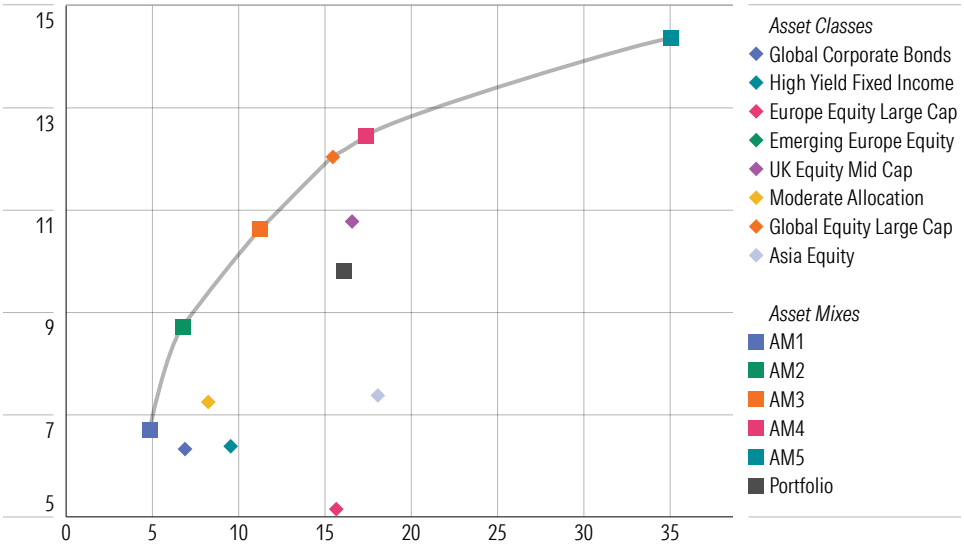
Examining the Data Driving Asset Allocation Strategies

One metric we didn't touch on yet is correlation. Correlation is a measure of how closely the returns of securities move in line with each other: a positive correlation means if one rises or falls, the other tends to do the same; a negative correlation means they tend to do the opposite; and a correlation close to zero means they move independently of each other.

Many asset classes have low correlations with each other because they are driven by different factors. For example, when investors are confident in the macroeconomic and geopolitical backdrop, stock markets generally perform well. Government bonds, in contrast, generally perform well in risk-off environments because they are seen as safer investments. Therefore, combining equities with another asset class, such as government bonds, can smooth a portfolio's returns and reduce its maximum loss. It's important to note that correlations can sometimes rise in sharp market downturns, like the one we witnessed in April 2025.

It's possible to plot every theoretical combination of assets on a graph, such as the one below, in which portfolio risk is on the x-axis and expected return is on the y-axis. We can see in the chart that all of the most efficient portfolios can be joined together by a curved line known as the efficient frontier.

Arithmetic Mean



Source: Morningstar Research. Data as of June 30, 2024.

Many investment teams build quantitative models to help them find the combination of assets that offers the best possible risk-adjusted returns for a given set of constraints. These models may consider factors such as asset class valuations, bond yields and the momentum of asset class returns.

Other managers prefer predominantly fundamental, bottom-up-based asset allocation techniques. These rely primarily on in-depth fundamental analysis of the various asset classes to determine which are the most attractive investments.

Other approaches are based on an assessment of variables including market conditions, the macroeconomic outlook and political developments, coupled with diversification analysis to determine the asset allocations that the managers believe are most likely to prosper.

Quantitative models help process all the information involved in determining capital market assumptions, but a purely quantitative approach rarely produces a portfolio that is likely to perform robustly in all market conditions. There's a lot to be said for a combined fundamental-quantitative approach. A popular technique that combines quantitative and fundamental inputs is the Black-Litterman model. It enables fundamental managers to input their chosen allocation in the model, then uses quantitative techniques to enhance the allocation.

After an asset allocation has been determined comes the question of how long to stick with it. Some investors choose to stand by their strategic asset allocation, picking fixed asset weights and regularly rebalancing back to them by selling the winners and buying the losers. Others adopt a more active approach through tactical asset allocation—tilting portfolio weights around the strategic asset allocation based on their near-term expectations for asset class performance, despite the known challenges of outperforming the market over the short term. While there's clear scope to add value through tactical asset allocation, it does involve the risk of underperforming the strategic asset allocation and can expose investors to increased transaction costs, hitting the returns they ultimately receive.

The Morningstar asset allocation approach is valuation-driven. It is deeply rooted in comparing an asset's current price with our estimate of its intrinsic value—the value of its underlying cash flows. Morningstar believes that risk is very much affected by valuation, with assets becoming riskier as they become more overpriced.

While Morningstar builds portfolios with the long term in mind, that doesn't mean we don't adjust. We refer to our asset allocation as dynamic rather than tactical, only making modest changes when they are fully warranted. This means we keep transactions costs low, helping us maximize returns.

Morningstar Helps Investment Teams Manage Risk

Investment teams can lean on Morningstar data, research, and analysis to manage risk. Our Global Risk Model helps to identify, assess, and forecast the amount of risk in investments. By tracking a stock's underlying economic exposure to a variety of factors, including equity factors both unique to Morningstar and standard across the industry along with Multi Asset Factors, the model lets you quickly see how a variety of market conditions could affect a portfolio.

Morningstar Direct, our investment analysis application brings together global data sets, research, and analytics. The tool empowers users to create, edit, and analyze portfolios in one place.

There are many ways to search, sort, and filter securities and funds to aid portfolio diversification. They can be ranked and organized by total net assets, regional category groups like US equity and International Equity, Morningstar categories, like Large Growth or Foreign Large Blend, or Morningstar ratings, like the Star Rating or ESG Risk ratings.

Users can also understand how potential risks like volatility and interest rate hikes would affect a portfolio by modeling and stress testing adverse conditions during portfolio construction. You can see how tweaking positions and asset-class weightings would affect the projected performance of the overall portfolio.

Morningstar Direct's portfolio holdings look-through functionality provides a detailed view of a fund's or portfolio's composition, extending beyond high-level securities. Our data reveals the underlying assets held in vehicles such as mutual funds or ETFs, offering crucial insights into an investment's true structure and risk exposure. With access to up to ten levels of holdings, users gain unmatched transparency and a deeper understanding of their portfolios.

This enhanced view helps investment teams identify potential overconcentration, whether in sectors or individual securities, and make more informed tactical asset allocation decisions. What otherwise might require complex, manual data manipulation is now streamlined, as users can uncover these insights with just a few clicks.

By leveraging Morningstar's robust tools and vast datasets, investment teams can diversify their portfolios, manage risks more effectively, and optimize returns with confidence.

Take a tour of Direct.

Free two-week trials of Morningstar Direct are available for investment team members who want to explore the application. A Morningstar representative can also be scheduled for guided tours and in-depth conversations about use cases and workflows.

Schedule a two-week trial of Direct.