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Choose your hedges wisely...and often

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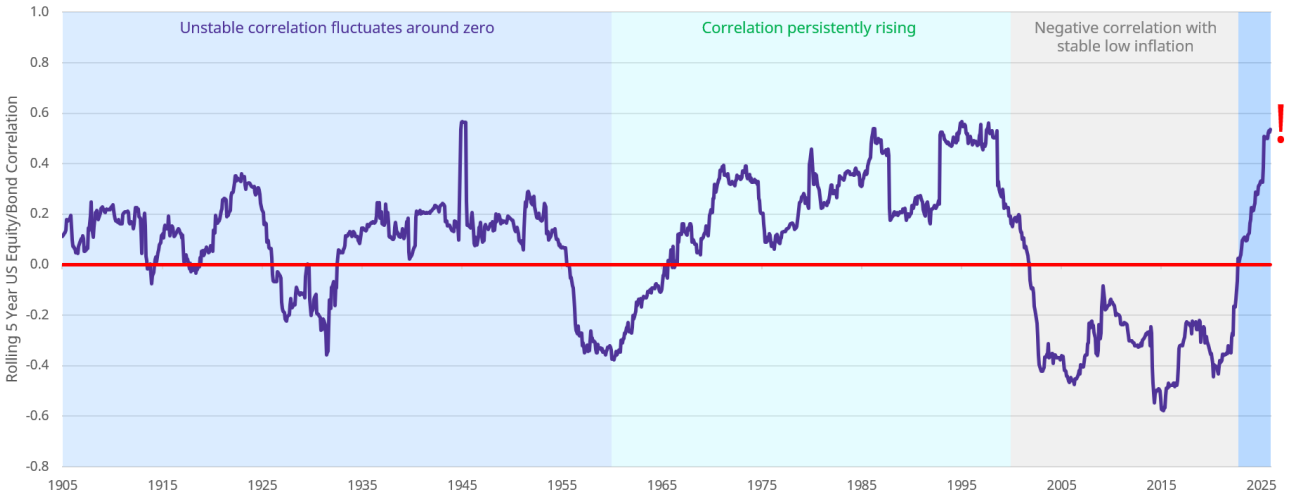
For decades, the investment community operated under a comfortable assumption: asset allocation could be largely outsourced to a static formula. By blending a dominant share of growth assets with a fixed sleeve of government bonds, diversification was expected to automatically smooth out market turbulence. It was a beautifully simple framework, rooted in the predictable inverse relationship between corporate profitability and sovereign debt.

However, the structural economic pillars supporting that reliable paradigm have cracked. The prolonged macro environment of negligible inflation, rock-bottom interest rates, and predictable central bank liquidity has given way to a far more volatile regime marked by persistent price pressures, aggressive fiscal spending, and sudden geopolitical flare-ups. The market has been used to worrying about demand shocks, but now we live in a world filled with supply shocks, which is an entirely different regime.

In this friction-filled environment, traditional asset correlations have a dangerous habit of breaking down precisely when market stress peaks. And nowhere is this vulnerability more apparent than in the rigid implementation of portfolio hedges.

Many investors still treat risk mitigation as a permanent, set-and-forget defensive bucket. They allocate capital to a specific safe haven - whether it is long-duration treasuries, defensive currencies, or gold – and trust that it will act as an effective shield whenever equity markets pull back. But when macro regimes shift, yesterday's reliable hedge can rapidly transform into tomorrow's concentrated risk asset. Successfully shielding capital today demands continuous tactical adjustments rather than static endurance. Indeed, managing downside risk must be treated as an active, evolving process that moves with markets.

US Equity / Bond Correlation



Source: Schroders as of 31 December 2025

The trap of the static hedge: A tale of two crises

The danger of a passive approach to risk mitigation becomes blindingly obvious when analysing how different geopolitical disruptions have reverberated through global markets over the past two years. Investors who blindly applied the lessons of the previous crisis to the next face sudden and severe capital impairment. We can see this friction clearly by contrasting the market behaviour surrounding Liberation Day in 2025 with the Iran Conflict of 2026.

Liberation Day 2025: The sell America trade

During the market anxiety of 2025, asset prices moved in alignment with the belief that the uncertainty of a Trump presidency would lead to a wholesale reduction in US assets:

- **Currencies:** The US Dollar (USD) weakened, while international pairs like the Euro (EUR) and Japanese Yen (JPY) caught strong bids.
- **Precious Metals**: Gold served its traditional purpose, outperforming the broader market as an alternative store of value.
- **Equities:** Capital moved away from American corporations, triggering a notable rotation into international equity markets.
- **Fixed Income:** The US Treasury yield curve steepened as long-term growth and inflation expectations adjusted.

This particular backdrop heavily rewarded portfolios that relied on precious metals and unhedged global currency allocations for protection, but long duration bonds flipped and became the risk asset.

Iran Conflict 2026: The playbook flips

When geopolitical tensions escalated into open conflict in Iran the following year, the exact same defensive playbook would have hurt portfolios:

- **Currencies:** The USD defied the previous year's trend, rallying aggressively against major trade-weighted pairs, while the EUR and JPY weakened sharply.
- **Precious Metals:** Gold failed to act as a buffer; instead, it experienced an intense sell-off and underperformed dramatically.
- **Equities:** Rather than diversifying globally, market participants pulled liquidity from international assets and rotated straight back into the safety of expensive US large-caps.
- **Fixed Income:** The US Treasury yield curve flattened rather than steepened.

This rapid divergence shows how a defensive position is only effective if it matches the specific structural drivers of the current crisis. Gold behaves exceptionally well in a monetary debasement environment – one defined by synchronised interest rate cuts, unchecked fiscal stimulus, and highly accommodative central banks. That was the story driving 2025. Conversely, broad commodity baskets excel during acute supply-side shocks, which came to define the market architecture of 2026. Maintaining a static hedge out of sheer habit means accepting uncompensated exposure.

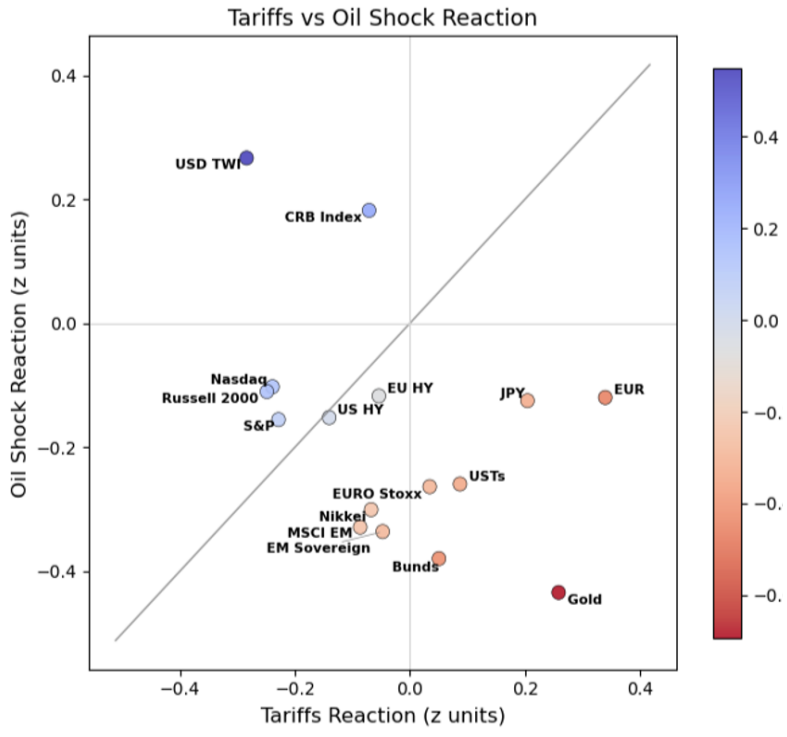


Chart source: UBS, Schroders

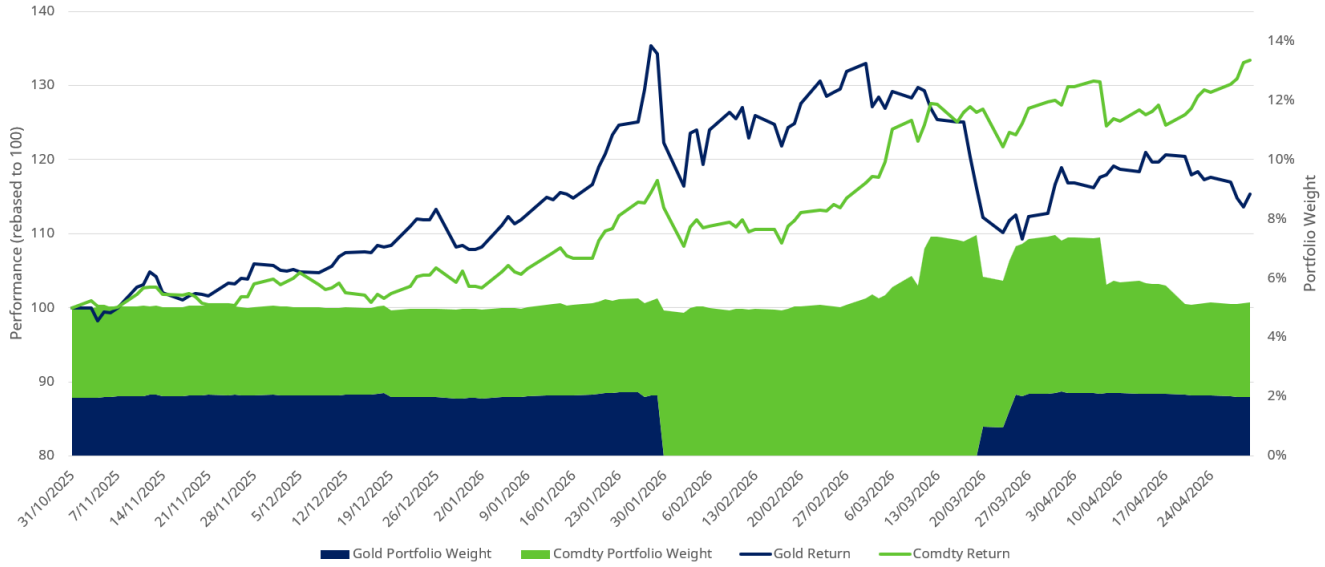
Navigating bonds, commodities and FX in 2026

At Schroders, we consciously avoid managing portfolios in isolated, rigid asset sleeves. Guided by our Total Portfolio Approach (TPA), we assess how the entire fund behaves collectively when confronted by shifting liquidity, changing yields, and real-world geopolitical events. This flexible philosophy directly dictated our tactical manoeuvres throughout the volatility of 2026.

The Gold-to-Commodity Pivot

Early in the year, we monitored the immense retail and institutional enthusiasm for precious metals, highlighted by extreme speculator positioning and even queues of retail investors outside physical gold stores as gold prices surged toward historic highs. Recognising that the asset was approaching a near-term ceiling around USD 5,300 to 5,500, we crystallised our gains. We liquidated our entire physical gold position and reallocated that capital directly into broad commodities (we also reduced our gold miner position by over 60%). By tilting the exposure more heavily towards energy and agriculture, the portfolio achieved vital insulation just as the conflict in Iran emerged.

Adjusting our commodities exposure as valuations and positioning became stretched



Source: Schroders, Bloomberg. Performance rebased to 100 on 31 October 2025. Excludes equity exposure to gold miners.

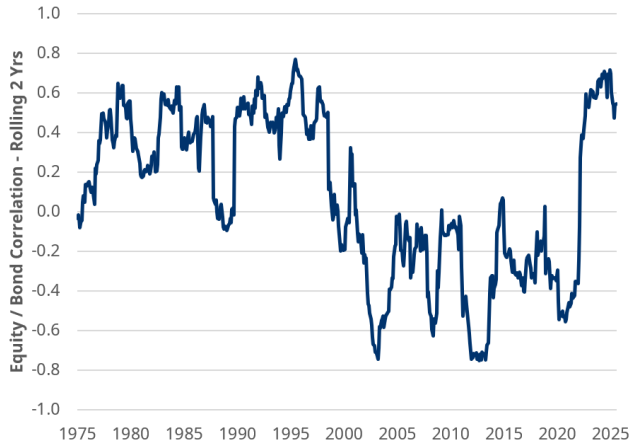
When the Strait of Hormuz was shut down, we pushed our commodity allocation further from 5% up to 7.5%. This step was taken because a supply-chain blockade functions as a direct supply shock that feeds commodity prices while placing immense short-term liquidity pressure on gold. Central banks across Russia, Turkey, and various Gulf states were suddenly forced to liquidate their gold holdings to access the physical US Dollars required for urgent defence procurement.

As these immediate constraints began to ease, we pivoted once again, trimming the broad commodity allocation back to 4% and establishing a fresh 2% position in gold. While gold experiences short-term headwinds while primary shipping routes face pressure, its long-term structural tailwinds remain strong. Developing nations are highly unlikely to step up their accumulation of US Treasuries over the long run; they will inevitably return to buying physical gold as soon as regional stability is restored. Navigating these waves demands constant agility, not a passive buy-and-hold mentality.

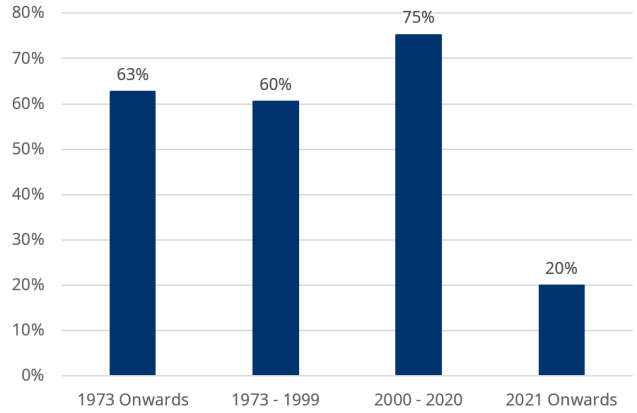
Tactical duration and curve steepening

Government bonds are the ultimate casualty of a "set-and-forget" mindset. Treating duration as a permanent defensive anchor is highly dangerous when supply shocks pull yields and equity risks in the same direction. As the graph below shows, since the onset of the COVID-19 pandemic, bonds have in aggregate failed to diversify equity risk.

US equity bond correlation - Rolling 2Y correlation



Likelihood of a positive bond return when equity falls over one month



Source: Schroders, LSEG. Analysis is based on monthly returns data for US equities and bonds from January 1973 to August 2025. US equity return is based on the S&P 500 Index, US bond return is based on the Bloomberg US Treasury Index. Past performance is not a guide to future performance and may not be repeated.

However, the breakdown of negative equity-bond correlations has not rendered bonds obsolete. Actively managed, they still provide a key source of carry, capital gain and diversification.

In navigating this new regime, we shifted our fixed income playbook away from broad macro bets toward highly localised curve positioning. When the Iran crisis broke out, bonds initially rallied as markets moved to a risk off tone. We used this as an opportunity to readjust our fixed income positioning, given our view that an oil supply shock would push inflation higher, particularly in those markets more exposed to energy prices. Because front-end yields remain highly correlated with oil shocks, any reignition of the Gulf conflict could easily trigger a spike in yields and inflict losses on our duration. We were already negative on duration given our view that it was unlikely the US Federal Reserve was going to cut rates when their economy was strong, their job market was recovering, and inflation remained well above target. When the crisis broke out, we adjusted the portfolio's interest rate exposures quickly. We trimmed duration risk at the front end of the curve across the US and Germany, reflecting our expectation that higher oil prices would feed through to inflation and push bond yields higher.

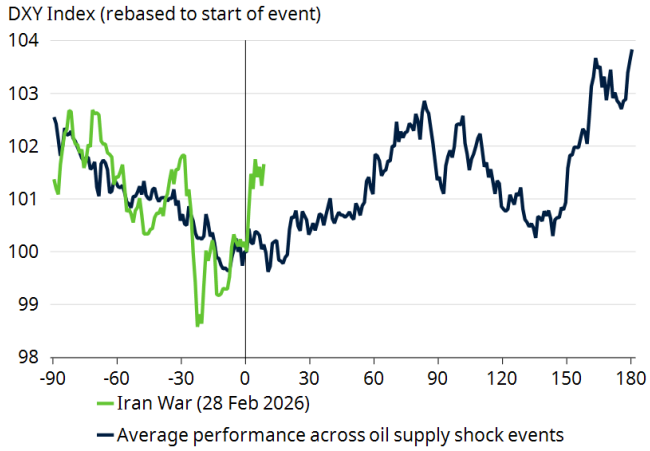
We viewed the USD as a beneficiary of safe haven flows, we reduced our exposure to emerging market local currency bonds, as EM central banks would need to back away from their policy easing stance. Once central bank rate hikes started to be priced by the market, we used this to reallocate back to shorter maturity bonds, net adding back to interest rate exposure. Over the following weeks the market started to price in three rate hikes in the Eurozone, the market went from pricing in three rate cuts in the US to pricing in over 1 rate hike, and Australia saw a terminal rate being priced at 4.7%. We thought this was more appropriate and therefore started reallocating back to duration, particularly bonds less than 5 years to maturity.

The US Dollar as a positive carry hedge

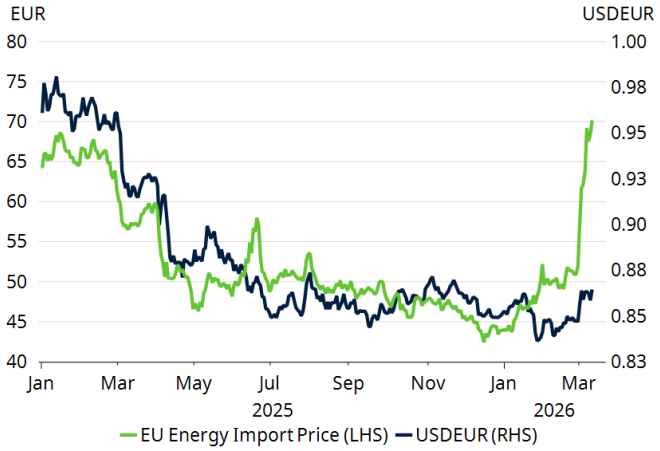
Crucially, in line with our Total Portfolio Approach, these additions were never left to run as isolated or static positions. The movement in front-end bonds would have direct impacts on currencies. If the geopolitical crisis escalates, the long USD exposure stands to profit from safe-haven flows and oil-exporter dynamics, directly offsetting our fixed-income drawdowns. By dynamically pairing curve exposure with an FX overlay, we converted traditional fixed-income risk into a highly coordinated defensive shield.

Despite last year's narrative to "Sell America", the USD provided its traditional safe-haven properties during the Iran crisis. When trade breaks down or you urgently have to rush to purchase goods or commodities, the USD is one of the few currencies that can handle it. Crucially, the USD maintains its relative strength against the EUR, meaning global macro conditions are paying investors an attractive positive carry simply to short alternative currencies against the greenback. Typically, the USD rallies against the EUR in energy crises. In an environment where capital is no longer free, the greenback serves as a highly efficient defensive instrument. Holding USD against the EUR pays you to wait It rewards you with yield while you hold it, while preserving the asymmetric upside to rally sharply if maritime supply routes remain blocked or geopolitical conflicts intensify.

USD historically outperforms during oil supply shocks



Energy will weigh on the EUR if conflict continues



Source: Schroders, Macrobond, 12 March 2026. Past performance is not a guide to future performance and may not be repeated. The forecasts included should not be relied upon, are not guaranteed and are provided only as at the date of issue. For illustrative purposes only.

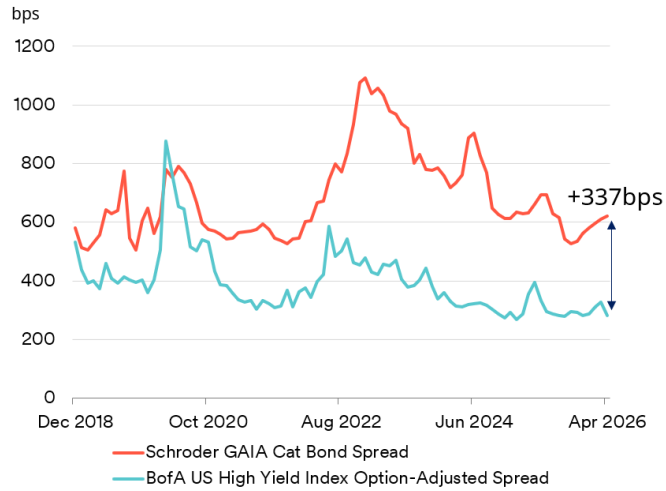
Expanding the Toolkit: Insurance-Linked Securities (ILS)

True dynamic risk management also requires looking beyond standard sovereign bonds and currencies to source diversification benefits. Relying on traditional high-yield corporate credit or convertible bonds to help improve a portfolio's income can expose an investor to substantial drawdowns when economic growth loses momentum or corporate balance sheets come under pressure.

For this reason, we hold strong conviction in Insurance-Linked Securities (ILS), also known as Cat Bonds. For portfolios unfamiliar with this niche part of the market, ILS offers an exceptionally clean risk-reward profile because its core performance is tied strictly to natural catastrophe metrics rather than corporate cash flows, interest rate decisions, or equity benchmarks. That makes ILS uncorrelated to other asset classes, both in return but also fundamentally. It helps that the allocation is yielding more than high yield corporates, despite having a lower drawdown profile and enhanced correlation benefit.

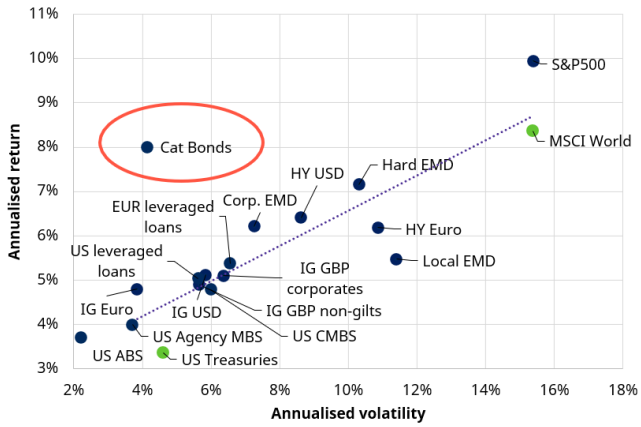
Capturing an asset that offers an insulated income stream, while completely decoupling from equity market beta, is a prime example of how modern diversified portfolios should be built.

Schroder GAIA Cat Bond spreads vs. BB-rated bonds



Cross-credit risk-return profile

Since January 1997 or inception



Source: LHS – Schroders Capital, Federal Reserve Bank of St. Louis, ICE, 30 April 2026. RHS – Schroders, LSEG Datastream, ICE Data Indices, J.P. Morgan, Credit Suisse. Data as at 31 December 2025. All return and volatility figures shown as USD hedged, except EMD Local and MSCI World which are unhedged returns in USD. Past performance is not a guide to future performance and may not be repeated.

Conclusion: Portfolios must adapt

Expecting a single static asset class to perform an unvarying task - relying blindly on equities to manufacture returns and standard bonds or gold to provide permanent cover - is an outdated luxury from a bygone era. The post-GFC period of zero inflation and unconditional central bank support was a historical anomaly, not the default setting. Looking across centuries of financial history, inflationary cycles, structural supply disruptions, and shifting asset correlations are normal characteristics of the global economy.

The Schroder ISF Global Target Return Fund is explicitly engineered around this reality. Our process focuses entirely on absolute real-world objectives - targeting absolute returns of US dollar cash +5% over rolling three-year horizons - by dynamically shifting exposure across growth, defensive, and alternative roles.

We do not modify portfolio weights for the sake of turnover; we trade because the underlying distribution of macro risks changes rapidly, with even faster adjustments to market pricing. To protect purchasing power and grow real wealth over time, staying static is no longer a viable defensive strategy. Investors must possess the flexibility to scour the full asset horizon, and the active conviction to choose their hedges wisely.

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