ETF Industry Perspectives Q2 2025

Stay disciplined amid volatility

Vanguard ETF Industry Perspectives is our quarterly in-depth commentary, with analysis of key trends and how they're affecting ETF investors.

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Key highlights

- **Equity spotlight:** The question of whether client portfolios are overallocated to high-flying growth stocks continues to loom large—even with the recent pullback in equities. Our research shows that advisors are already tilting client portfolios away from large-capitalization stocks. But that doesn't necessarily solve for a home bias that's manifesting in client portfolios as well. One way to address this could be to add slightly more international stocks into the mix, which would address any valuation discrepancies and solve for at least some home bias.

- **Fixed income spotlight:** The first quarter was marked by uncertainty and rising market volatility, prompting us to revisit our bond investing playbook. While the outlook for interest rates remains cloudy, higher yields and the return of the U.S. Treasury term premium make Treasury bonds a potentially attractive allocation to consider. All that said, our view is consistent: Match duration risk with time horizon. It's basic bond market advice that can help keep your clients' longer-term investment goals on track, no matter what's happening in the markets or the economy.

Are investors too concentrated in overvalued U.S. equities?

Rallying U.S. stocks in recent years have made equity benchmarks including the Standard & Poor's 500 Index top-heavy with tech names such as Nvidia, Microsoft, and Amazon. But this phenomenon also spells an opportunity for advisors to potentially fine-tune clients' holdings to hew more closely to global strategic allocations.

Questions about overconcentration risk have been growing for over a year, and they've only grown louder following the recent pullback and volatility in equity markets. Do client portfolios suffer from overconcentration in large-cap U.S. equities? And more broadly, are domestic equities in general overvalued?

The intersection of overconcentration and home bias

While the market shows an outsized tilt toward the select companies in the Magnificent Seven, Vanguard research shows that advisors may have already been adjusting for this in client portfolios.

Our survey of 1,747 client portfolios shows that advisors are already tilting portfolios more toward small- and mid-cap stocks and away from the large- and mega-cap growth stocks that have rallied so much.[1] The median advisors in the survey have been overweighting small- and mid-caps by about 10 percentage points above benchmark allocations of around 25%.

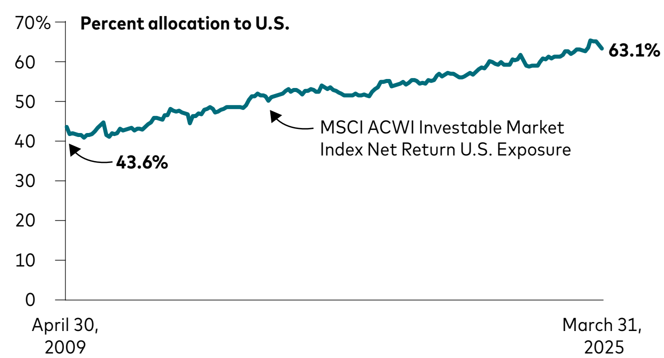
But while advisors appear to be reducing exposure to large-cap stocks, the other critical factor they may be overlooking is home bias to U.S. markets. Our research shows that the median client portfolio has a 75% weighting to U.S. stocks—well above the 63% allocation to U.S. equities in global benchmarks.[2]

That's an overweight of 12 percentage points, and well over three-quarters of client portfolios show some level of home bias.

Possible approaches to minimizing home bias

Considering the uncertainty around U.S. stock valuations moving forward, trimming at least some of that exposure can further help reduce concentration concerns. Prior to the March 2025 market volatility, U.S. stocks were at least two standard deviations more expensive than global stocks based on the last 20 years.[3]

Growing allocation to U.S. stocks in global index



Sources: Vanguard, based on data from Morningstar, Inc.

Market-cap indexes run the risk of a higher allocation to a handful of names that can make exposure seem top-heavy. Such indexes are arguably the best approach to owning a representative slice of the overall macroeconomy, but tilting away from companies within the U.S. market that have the largest returns addresses only one part of a portfolio's source of overconcentration.

Adding more international stocks can make portfolios more diverse—a benefit that could pay off if the current valuation gap between U.S. and international stocks normalizes over the long run.

1 Source: Vanguard Portfolio Analytics and Consulting team, for the 12 months ended June 30, 2024. *Advisor Portfolio Construction Trends and Insights: 2024 Midyear Update.*

2 Sources: Median client portfolio data are from the Vanguard Portfolio Analytics and Consulting team, as of June 30, 2024; allocation to U.S. equities in global benchmarks data are from MSC Inc., as of March 31, 2025.

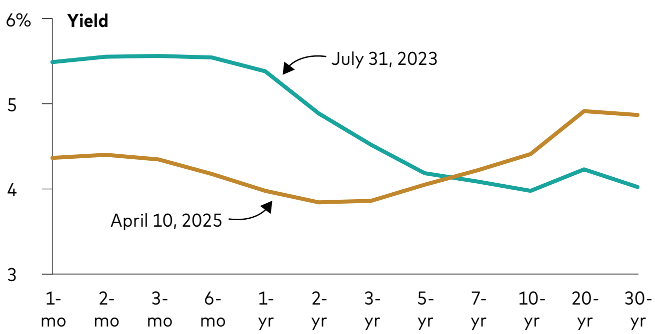
3 Source: Vanguard, as of June 30, 2024.

Maintaining perspective in an uncertain rate environment

Late in 2024's third quarter, the yield differential between 2-year and 10-year Treasury bonds turned positive for the first time in 522 days, marking the end of the longest period on record of 2-year/10-year yield-curve inversion.[4]

Although economic uncertainty remains, the absolute level of yields and the restoration of the Treasury term premium further out on the curve are possible reasons to rethink client allocation to Treasuries.

The U.S. Treasuries yield curve, then and now



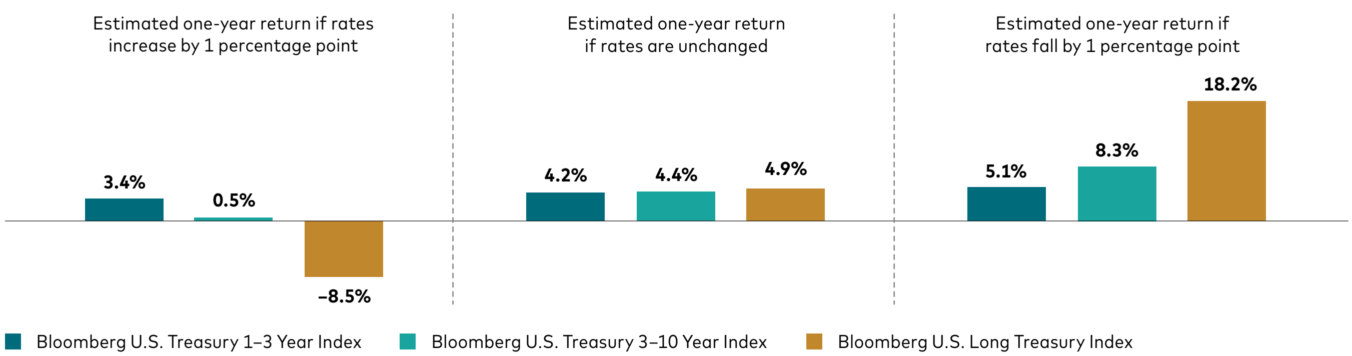
Sources: Vanguard, based on data from Morningstar, Inc.

Back to basics

As rising market volatility recently suggests, uncertainty in the economy is prevalent, with a wide range of potential outcomes for markets. As investors think about how to select their portfolio duration in this environment, it's important to consider the following:

- Term premium is back, as evidenced by an upward-sloping yield curve, meaning that investors can potentially capture higher yields by taking on duration risk for the first time in several years.
- The reemergence of negative correlation between equity and bond returns means that longer-term Treasury bonds can potentially now add both return *and* diversification. Amid the first quarter's equity volatility, changes in long-term yields counteracted much of the losses.
- There are multiple ways to invest along the yield curve. The higher-for-longer interest rates scenario allows investors with lower risk appetites to generate income by investing in the shorter end of the yield curve. Bond carry can absorb losses in a portfolio if rates rise from sustained long-term inflation. But if a market slowdown were to occur and longer-term yields were to fall with declining growth expectations, longer-duration bonds would stand to gain the most.

Yields add to upside and help cushion downside



Notes: The illustration is hypothetical and does not represent the return on any particular investment; the rates shown are not guaranteed. As of January 31, 2025, the Bloomberg U.S. Treasury 1–3 Year Index had a duration of 1.86 years and a yield to maturity of 4.22%. Yield-to-maturity comparisons reflect index returns. Yield to maturity is defined as total yield income of a bond portfolio if every bond in the portfolio at the time of the as-of date is held to maturity. The Bloomberg U.S. Treasury 3–10 Year Index had a duration of 4.90 years and a yield to maturity of 4.37%. The Bloomberg U.S. Long Treasury Index had a duration of 14.67 years and a yield to maturity of 4.86%. The scenario assumes that any interest rate changes occur at the beginning of the period and before any reinvestment of dividends; it does not take convexity into account.

Sources: Vanguard calculations, based on data from Bloomberg as of January 31, 2025.

Past performance is no guarantee of future returns. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index.

4 Sources: Vanguard analysis, based on data from the U.S. Department of the Treasury as of February 28, 2025.

What's an advisor to do?

Treasury yields at the end of 2024 were in the 90th percentile relative to Treasury yields over nearly the past decade.[5] Meanwhile, the Treasury yield curve is normalizing, increasing the attractiveness of duration risk. Our essential view is that Treasury ETFs can play a pivotal role in a portfolio offering income and diversification.

But at the end of the day, the question of where along the yield curve an investor should allocate is simply a function of matching duration risk with investment horizon.

5 Data from Bloomberg, from April 3, 2015, through March 31, 2025.

Important information

For more information about Vanguard funds or ETF Shares, contact your financial advisor to obtain a prospectus or, if available, a summary prospectus. Investment objectives, risks, charges, expenses, and other important information are contained in the prospectus; read and consider it carefully before investing.

Vanguard ETF Shares are not redeemable with the issuing Fund other than in very large aggregations worth millions of dollars. Instead, investors must buy and sell Vanguard ETF Shares in the secondary market and hold those shares in a brokerage account. In doing so, the investor may incur brokerage commissions and may pay more than net asset value when buying and receive less than net asset value when selling.

All investing is subject to risk, including the possible loss of the money you invest.

Investments in bonds are subject to interest rate, credit, and inflation risk.

Bond funds are subject to the risk that an issuer will fail to make payments on time, and that bond prices will decline because of rising interest rates or negative perceptions of an issuer's ability to make payments.

Prices of mid- and small-cap stocks often fluctuate more than those of large-company stocks.

U.S. government backing of Treasury or agency securities applies only to the underlying securities and does not prevent share-price fluctuations. Unlike stocks and bonds, U.S. Treasury bills are guaranteed as to the timely payment of principal and interest.

Funds that concentrate on a relatively narrow market sector face the risk of higher share-price volatility.

Be aware that fluctuations in the financial markets and other factors may cause declines in the value of your account. There is no guarantee that any particular asset allocation or mix of funds will meet your investment objectives or provide you with a given level of income. Diversification does not ensure a profit or protect against a loss.

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ETFTB 052025