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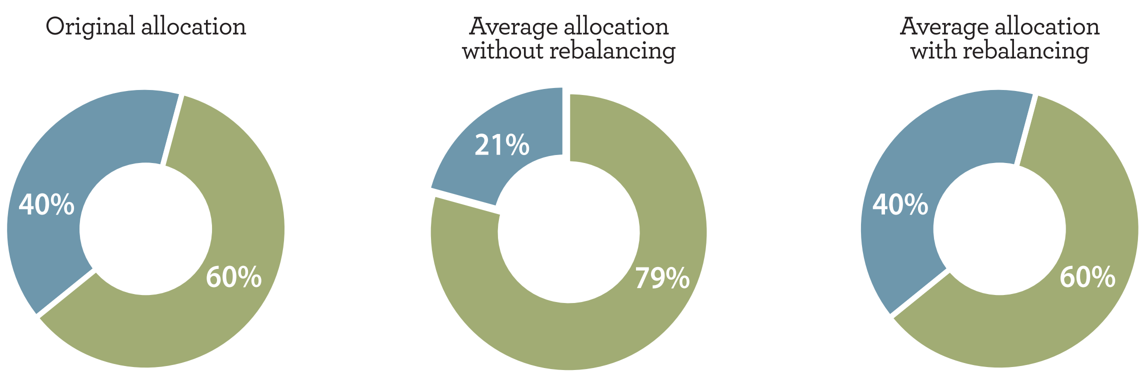
The Importance Of Rebalancing

Buy low and sell high is a strategy many investors hope to follow. But selling high can be challenging in markets like these, when many assets—particularly stocks—have risen considerably in a relatively short period of time. Large market moves can significantly alter a portfolio's risk/reward profile. That's why we believe now may be a good time for investors to review their portfolios. Rebalancing—taking profits and reallocating into areas that have underperformed—is an important component of an investment strategy that can help investors achieve their long term goals.[1]

The graphic below shows the potential effect the current prolonged equity bull market would have had on a hypothetical portfolio. It demonstrates why now may be a time to consider rebalancing, especially if this has not been done recently.

Investors should consider rebalancing in an effort to help manage risk

The center portfolio was allowed to drift away from its intended 40%/60% allocation (left portfolio). Although its return was similar, its volatility was 15% greater than the portfolio that wasn't allowed to drift (right portfolio).



Bonds
Stocks

Average annual return: 8.24%
Volatility of yearly returns: 9.98%[2]

Average annual return: 8.29%
Volatility of yearly returns: 8.69%[2]

Sources: Morningstar Direct, Wells Fargo Investment Institute; December 31, 2018. In this example, stocks are represented by the S&P 500 Index, and bonds are represented by the Bloomberg Barclays U.S. Aggregate Bond Index. Illustrations are for the period January 1, 1990 to December 31, 2018.

Index return information is provided for illustrative purposes only. Index returns do not represent investment performance or the results of actual trading. Index returns reflect general market results, assume the reinvestment of dividends and other distributions, and generally do not reflect deduction for fees, expenses, or taxes applicable to an actual investment. The S&P 500 Index is a market capitalization index composed of 500 stocks generally considered representative of the U.S. stock market. The Bloomberg Barclays U.S. Aggregate Bond Index is a broad-based index that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market. An index is unmanaged and not available for direct investment. **Past performance does not guarantee future results.**

1 Keep in mind, liquidating holdings could have tax consequences. Wells Fargo Investment Institute and its affiliates are not tax or legal advisors.

2 Volatility is measured using standard deviation of monthly returns, which is a statistic that reflects the degree of risk surrounding the outcome of an investment decision. The higher the standard deviation, the more the risk.

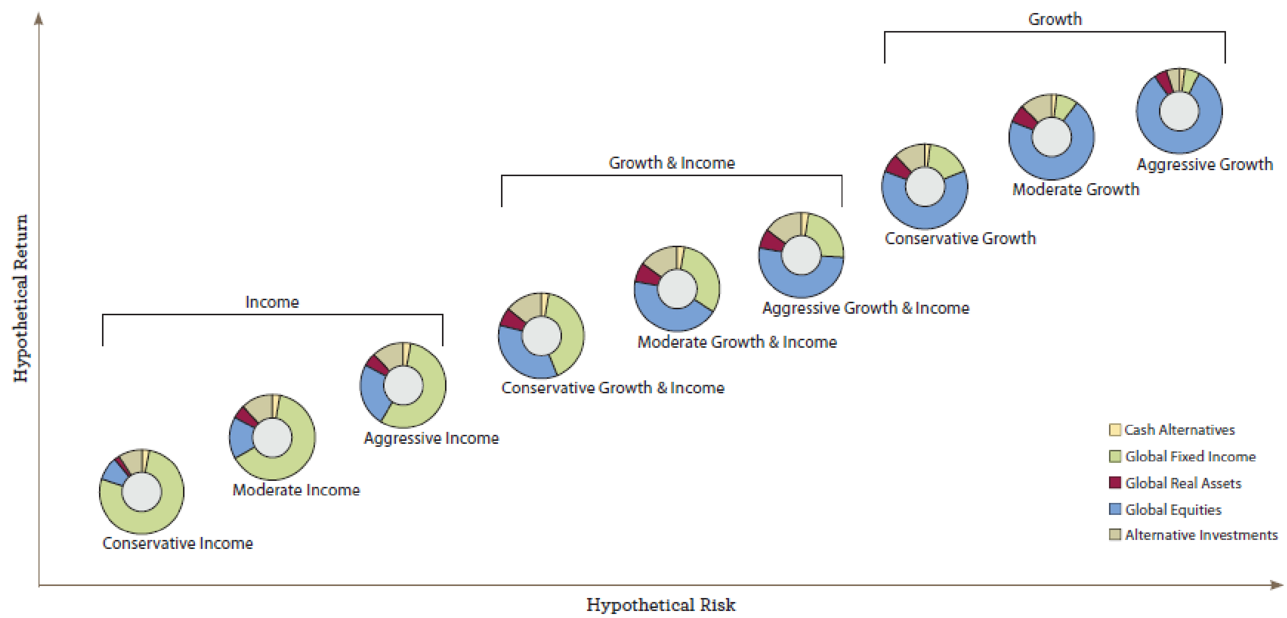
Get back to the basics

The idea of rebalancing assumes investors have implemented an asset allocation strategy to help reach their goals. How important is that? Research has shown that asset allocation is the major determinant of risk and return for a portfolio.[3] This goes contrary to what the financial media might have investors believe—that security selection is key to success as an investor. As a result, when the markets are volatile, it's especially important to block out the noise from the television and internet and focus on the fundamentals, such as the main building blocks for constructing an investment plan:

- **Financial goals.** The asset allocation for an investor who wants to retire in 30 years and travel the world might be different than it would be for the same investor who wants to retire in 10 years and start his own business. As a result, it's important for investors to keep financial goals top of mind.
- **Risk tolerance.** In general, as an investment's return potential increases, so does its risk. The key is a portfolio with an asset allocation that will help investors work toward their goals and not keep them awake at night.

The chart below conceptually shows a variety of different asset allocation strategies. Note that as the primary allocations shift from lower-return investments such as fixed income (primarily bonds) to higher-return investments such as equities (stocks), the hypothetical risk increases. Finding the right combination for each individual situation is crucial to being a successful investor.

Different objectives result in different risk and return characteristics



Source: Chart is conceptual and does not reflect any actual returns or represent any specific asset classifications.

3 Sources: "Determinants of Portfolio Returns," Wells Fargo Wealth Management, November 2011; Morningstar Direct; Roger G. Ibbotson and Rex A. Sinquefield, "Stocks, Bonds, Bills, and Inflation: Year-by-Year Historical Returns," University of Chicago Press Journal of Business (January 1976); Standard and Poor's; and Wells Fargo Wealth Management.

Is it time for a portfolio checkup?

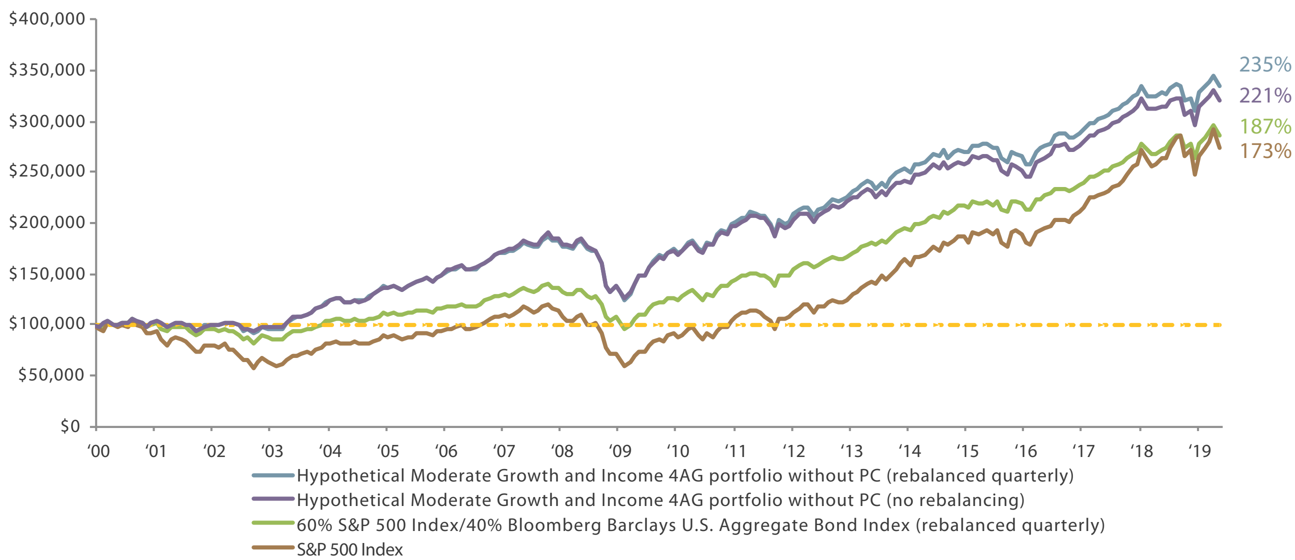
Once an asset allocation has been determined, remember that a "set it and forget it" mindset is unlikely to work in today's markets. To help keep a portfolio on track, investors should consult their financial advisor and review it at least annually to see if it needs rebalancing.

The chart below shows how rebalancing can help manage risk and may result in higher returns. It illustrates that a hypothetical Moderate Growth and Income portfolio would have provided higher returns from January 1, 2000, through May 31, 2019, when rebalanced quarterly. It's also interesting to note that, whether rebalanced or not, it would have outperformed both the less-diversified 60% stocks/40% bonds portfolio and the S&P 500 Index by itself. Of course, past performance is no guarantee of future results.

Keep in mind that rebalancing can be emotional. When stocks, for example, are on a tear, it may seem counterintuitive to sell assets that have done well and buy ones that are lagging, which is what rebalancing may require. However, by bringing a portfolio's risk back to the desired level, investors are more likely to stick to their plan, endure market downturns, and be better positioned to work toward their long-term goals.

In addition, the need for investors to rebalance can increase as they approach their investment goal or time horizon, such as retiring or sending a child to college, when life events shift their perspective and risk tolerance may be decreasing. Investors should be sure to take a fresh look at goals during a portfolio checkup and review whether investment goals, time horizon, and risk tolerance may be evolving.

Hypothetical benefits of diversification and rebalancing
January 2000 through May 2019



Sources: Morningstar Direct and Wells Fargo Investment Institute; as of May 31, 2019. Performance results for the Moderate Growth and Income Four Asset Group portfolio without private capital (PC); and 60% S&P 500 Total Return Index, 40% Bloomberg Barclays Aggregate Index portfolios are hypothetical and are presented for illustrative purposes only.

Performance results for the Four Asset Group without private capital and the 60/40 portfolios are hypothetical and for illustrative purposes only. Hypothetical results do not represent actual trading. The indices reflect the historical performance of the represented assets and assume the reinvestment of dividends and other distributions. Index returns reflect general market results and do not reflect actual portfolio returns, the experience of any investor, or the impact of any fees, expenses, or taxes applicable to an actual investment. Because the HFR indices are calculated based on information that is voluntarily provided their actual returns may be higher or lower than those reported. Unlike most asset class indices, HFR Index returns reflect deduction for fees and expenses. An index is unmanaged and not available for direct investment. **Hypothetical and past performance does not guarantee future results**. Please see the end of the report for the risks associated with the representative asset classes and the definitions of the indices.

Moderate Growth and Income Four Asset Group model portfolio without private capital: 3% Bloomberg Barclays 1–3 Month Treasury Bill Index, 11% Bloomberg Barclays U.S. Aggregate Bond Index (5–7Y), 6% Bloomberg Barclays U.S. Aggregate Bond Index (10+Y), 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 3% JPM GBI Global ex.-U.S., 5% JPM EMBI Global, 20% S&P 500 Index, 8% Russell Midcap® Index, 6% Russell 2000® Index, 5% MSCI EAFE Index (USD), 5% MSCI EM Index (USD), 5% FTSE EPRA/NAREIT Developed Index, 2% Bloomberg Commodity Index, 3% HFRI Relative Value Index, 6% HFRI Macro Index, 4% HFRI Event-Driven Index, 2% HFRI Equity Hedge Index.

Index definitions

The **Bloomberg Barclays 1–3 Month Treasury Bill Index** includes all publicly issued zero-coupon U.S. Treasury bills that have a remaining maturity of less than three months and more than one month, are rated investment grade, and have $250 million or more of outstanding face value. In addition, the securities must be denominated in U.S. dollars and must be fixed rate and nonconvertible.

The **Bloomberg Barclays U.S. Aggregate Bond Index** is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities.

The **Bloomberg Barclays U.S. Aggregate 5–7 Year Bond Index** is unmanaged and is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of five to seven years.

The **Bloomberg Barclays U.S. Aggregate 10+ Year Bond Index** is unmanaged and is composed of the Bloomberg Barclays U.S. Government/Credit Index and the Bloomberg Barclays U.S. Mortgage-Backed Securities Index and includes Treasury issues, agency issues, corporate bond issues, and mortgage-backed securities with maturities of 10 years or more.

The **Bloomberg Barclays U.S. Corporate High Yield Bond Index** covers the universe of fixed-rate, non-investment-grade debt.

The **Bloomberg Commodity Index** is a broadly diversified index composed of 22 exchange-traded futures on physical commodities and represents 20 commodities weighted to account for economic significance and market liquidity.

The **FTSE EPRA/NAREIT Developed Index** is designed to track the performance of listed real estate companies and REITs in developed countries worldwide.

The **HFRI Relative Value (Total) Index** is managed by maintaining positions in which the investment thesis is predicated on realization of a valuation discrepancy in the relationship between multiple securities. Managers employ a variety of fundamental and quantitative techniques to establish investment theses, and security types range broadly across equity, fixed-income, derivative, or other security types.

The **HFRI Macro (Total) Index** is managed by trading a broad range of strategies in which the investment process is predicated on movements in underlying economic variables and the impact these have on equity, fixed-income, hard currency, and commodity markets. Managers employ a variety of techniques: both discretionary and systematic analyses, combinations of top-down and bottom-up theses, quantitative and fundamental approaches, and long- and short-term holding periods.

The **HFRI Event-Driven (Total) Index** is managed by maintaining positions in companies currently or prospectively involved in corporate transactions of a wide variety, including but not limited to mergers, restructurings, financial distress, tender offers, shareholder buybacks, debt exchanges, security issuance, or other capital structure adjustments.

The **HFRI Equity Hedge (Total) Index** is managed by maintaining positions both long and short in primarily equity and equity derivative securities.

The HFRI Indices are based on information self-reported by hedge fund managers that decide, on their own, at any time, whether or not they want to provide, or continue to provide, information to HFR Asset Management, LLC (HFR). Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these indices may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways.

The **J.P. Morgan Global Ex United States Index (JPM GBI Global Ex-US)** is a total return, market-capitalization-weighted index that is rebalanced monthly and consists of the following countries: Australia, Germany, Spain, Belgium, Italy, Sweden, Canada, Japan, United Kingdom, Denmark, Netherlands, and France.

The **J.P. Morgan Emerging Market Bond Index Global (EMBI Global)** currently covers 27 emerging-market countries. Included in the EMBI Global are U.S.-dollar-denominated Brady bonds, Eurobonds, traded loans, and local-market debt instruments issued by sovereign and quasi-sovereign entities.

The **MSCI EAFE Index** is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity-market performance of developed markets, excluding the U.S. and Canada.

The **MSCI Emerging Markets Index** is a free-float-adjusted market- capitalization-weighted index that is designed to measure equity-market performance of emerging markets.

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The **Russell Midcap® Index** measures the performance of the 800 smallest companies in the Russell 1000® Index.

The **Russell 2000® Index** measures the performance of the 2,000 smallest companies in the Russell 3000® Index, which represents approximately 8% of the total market capitalization of the Russell 3000 Index.

The **S&P 500 Index** is a market-capitalization-weighted index composed of 500 widely held common stocks and is generally considered representative of the U.S. equity market.

Risk considerations

All investing involves risks including the possible loss of principal. **Rebalancing** cannot eliminate the risk of fluctuating prices and uncertain returns. **Rebalancing** also does not guarantee profit or protect against loss in declining markets.

Different investments offer different levels of potential return and market risk. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small- and mid-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Growth stocks** may be more volatile than other stocks and there is no guarantee growth will be realized. There are no guarantees that **value stocks** will increase in value or that their intrinsic values will eventually be recognized by the overall market. Both growth and value types of investing tend to shift in and out of favor. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates. **High yield (junk) bonds** have lower credit ratings and are subject to greater risk of default and greater principal risk. The **commodities** markets are considered speculative, carry substantial risks, and have experienced periods of extreme volatility. Investing in a volatile and uncertain commodities market may cause a portfolio to rapidly increase or decrease in value which may result in greater share price volatility. **Real estate** has special risks including the possible illiquidity of underlying properties, credit risk, interest rate fluctuations and the impact of varied economic conditions. **Alternative investments** carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. They are complex investment vehicles which generally have high costs and substantial risks. The high expenses often associated with these investments must be offset by trading profits and other income. They tend to be more volatile than other types of investments and present an increased risk of investment loss. There may also be a lack of transparency as to the underlying assets. Other risks may apply as well, depending on the specific investment product.