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# Rebalancing's role in a recovery

## Key takeaways

- Rebalancing after the 2020 bear market would have resulted in a quicker recovery from the March 2020 lows even if investors did not rebalance precisely at the market bottom.

## What it may mean for investors

- Regular rebalancing can enhance investment performance even when the market is up, as it maintains an investor's desired risk profile and the portfolio can respond as expected.

Many investors strive to buy low and sell high, but this strategy can be challenging when markets sell off and recover quickly, as they did in 2020. The February/March 2020 bear market provided an attractive opportunity for investors to rebalance portfolios and return to strategic equity weightings ahead of the recovery. Yet, the swift pace of the rebound may have left many investors feeling like they missed the opportunity to rebalance at the bottom. Rebalancing portfolios on a regular schedule — such as quarterly or at other points during the recovery — still would have proven to be beneficial even without rebalancing precisely at the market bottom.

A hypothetical Moderate Growth and Income (MGI) portfolio that had been rebalanced quarterly outperformed a portfolio that was allowed to drift during the bear market and recovery, which highlights the importance of routine rebalancing. Interestingly, the quarterly-rebalanced and non-rebalanced portfolios both ended the third quarter of 2020 back at or very close to the strategic target 3% cash, 54% stocks, and 43% bonds allocation, but the return trajectories for those two allocations were very different. A quarterly-rebalanced portfolio, rebalanced at quarter end, aligned very closely with the market bottom on March 23. However, rebalancing at quarter end is just one example of a rebalancing approach.

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**Table 1. Hypothetical Moderate Growth and Income (MGI) portfolios established on 1/1/2020 with different rebalancing dates**

| Hypothetical MGI portfolios and global market indexes | 1/1/2020–9/30/2020 return (%) | Date recovered from bottom | Allocation ending 3/31/2020 | Allocation ending 9/30/2020 |
|---|---|---|---|---|
| MGI rebalanced at market bottom (3/23/20) | 5.01 | 6/8/2020 | 2% cash/56% stocks/40% bonds/2% commodities | 2% cash/59% stocks/38% bonds/2% commodities |
| MGI with quarterly rebalancing (rebalanced on 3/31/20, 6/30/20, and 9/30/20) | 3.04 | 7/31/2020 | **2% cash/54% stocks/42% bonds/2% commodities** | **2% cash/55% stocks/41% bonds/2% commodities** |
| MGI rebalanced on 4/30/20 | 2.41 | 8/5/2020 | 2% cash/49% stocks/47% bonds/2% commodities | 2% cash/58% stocks/38% bonds/2% commodities |
| MGI rebalanced on 5/31/20 | 2.16 | 8/5/2020 | 2% cash/49% stocks/47% bonds/2% commodities | 2% cash/57% stocks/39% bonds/2% commodities |
| MGI rebalanced on 6/30/20 | 2.02 | 8/5/2020 | 2% cash/49% stocks/47% bonds/2% commodities | 2% cash/56% stocks/40% bonds/2% commodities |
| MGI rebalanced on 7/31/20 | 1.90 | 8/5/2020 | 2% cash/49% stocks/47% bonds/2% commodities | 2% cash/56% stocks/40% bonds/2% commodities |
| MGI with no rebalancing | 1.84 | 8/5/2020 | **2% cash/49% stocks/47% bonds/2% commodities** | **2% cash/55% stocks/42% bonds/2% commodities** |

| Global market indexes | 1/1/2020–9/30/2020 return (%) | Date recovered from bottom |
|---|---|---|
| MSCI All Country World Index | 1.77 | 8/18/2020 |
| Bloomberg U.S. Aggregate Bond Index | 6.79 | 6/26/2020 |

Sources: © 2021 – Morningstar[1] and Wells Fargo Investment Institute, as of August 23, 2021. YTD=year-to-date. Cash represented by Bloomberg U.S. Treasury Bill (1–3 Month) Index. Stocks represented by S&P 500 Index, Russell Midcap Index, Russell 2000 Index, MSCI EAFE Index, and MSCI Emerging Market Index. Bonds represented by Bloomberg U.S. Aggregate Bond Index, Bloomberg U.S. Corporate High Yield Index, and JPM EMBI Global Index. Commodities represented by Bloomberg Commodities Index. Performance results for the Moderate Growth and Income (MGI) liquid (three asset group) portfolio are hypothetical and are presented for illustrative purposes only. Hypothetical results do not represent actual trading. An index is unmanaged and not available for direct investment**. Hypothetical and past performance do not guarantee future results.** Please see end of report for the MGI liquid (3AG) portfolio composition and risks associated with the representative asset classes and index definitions.

If an investor had the foresight and precision to rebalance exactly at the market bottom, their return would have exceeded all other rebalancing options and the portfolio would have recovered quicker than other rebalancing options. Yet, investors who rebalanced at other times during the impressive recovery from the March 2020 lows still would have benefitted from rebalancing either in overall return or recovery time (Table 1).

Even if an investor did not rebalance in March 2020, rebalancing in April, May, June, or July — while the market was moving higher — would have resulted in better returns than not rebalancing.

While portfolio rebalancing can be crucial during and following a downturn to potentially contribute to a higher return and quicker recovery time, rebalancing can also be crucial when markets move up. During bull markets, a non-rebalanced portfolio will typically drift to include a greater percentage of stocks than originally intended, as stocks typically increase in value faster than bonds. While this can lead to higher returns than a rebalanced portfolio as markets move higher, during a downturn the portfolio can suffer greater losses due to a higher exposure to riskier assets.

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Table 2 shows a hypothetical MGI portfolio that was established at the start of the previous bull market with a value of $1 million. The portfolio that was allowed to drift, reached a higher value during the bull market (March 9, 2009–February 19, 2020), but declined more than the regularly rebalanced portfolio during the last bear market (February 19, 2020–March 23, 2020). This resulted in a similar value at the end of the full market cycle (March 9, 2009–March 23, 2020), with $2.56 million for the portfolio rebalanced quarterly and $2.66 million for the non-rebalanced portfolio. While allowing the portfolio to drift resulted in a slightly higher value ($100,000 greater), it was at a greater cost in terms of risk ($400,000 greater drawdown). The rebalanced portfolio experienced a much smaller drawdown during the bear market and a lower standard deviation (volatility of returns) than the non-rebalanced portfolio while maintaining the desired target allocation and risk profile and achieving a higher risk-adjusted return.

**Table 2. Hypothetical MGI portfolios with a $1 million starting value established on March 9, 2009 with and without rebalancing**

| Hypothetical MGI portfolios and global market indexes | Maximum value during bull market | Minimum value during bear market | Maximum drawdown over full cycle | Full cycle return (annualized %) | Full cycle standard deviation (annualized %) | Full cycle Sharpe ratio | Date recovered from bottom |
|---|---|---|---|---|---|---|---|
| MGI with quarterly rebalancing | $3.30 M | $2.56 M | -$0.74 M | 8.90 | 8.42 | 1.12 | 7/31/2020 |
| MGI with no rebalancing | $3.80 M | $2.66 M | -$1.13 M | 9.28 | 10.27 | 0.92 | 8/25/2020 |
| MSCI All Country World Index | $4.42 M | $2.93 M | -$1.48 M | 10.24 | 14.09 | 0.84 | 8/18/2020 |
| Bloomberg U.S. Aggregate Bond Index | $1.58 M | $1.56 M | -$0.01 M | 4.11 | 2.95 | 1.22 | 6/26/2020 |

Sources: © 2020 – Morningstar[1] and Wells Fargo Investment Institute, as of October 13, 2020. Bull market: 3/9/2009–2/19/2020. Bear market: 2/19/2020–3/23/2020. Full cycle: 3/9/2009–3/23/2020. Performance results for the Moderate Growth and Income (MGI) liquid (three asset group) portfolio are hypothetical and are presented for illustrative purposes only. Hypothetical results do not represent actual trading. An index is unmanaged and not available for direct investment. **Hypothetical and past performance do not guarantee future results.** Please see end of report for the MGI liquid (3AG) portfolio composition and risks associated with the representative asset classes and index definitions. Sharpe ratio measures the additional return that an investor could expect to receive for accepting additional risk.

Investors may be tempted to abandon rebalancing during up markets to chase return, but doing so can also increase risk and leave the portfolio susceptible to a larger decline during downturns. Additionally, failing to rebalance during a bear market can leave the portfolio at risk for a longer recovery time. Regular rebalancing can enhance portfolio performance over time, even during bull markets, as it maintains an investor's desired risk profile. This, in turn, can help a portfolio weather market selloffs and could lead to a speedier recovery after a market correction.

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**Risk considerations**

Asset allocation cannot eliminate the risk of fluctuating prices and uncertain returns.

Each asset class has its own risk and return characteristics. 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. **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.

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**Index definitions**

An index is unmanaged and not available for direct investment.

**Moderate Growth & Income Liquid (three asset group) portfolio** = 2% Bloomberg U.S. Treasury Bill (1–3 Month) Index, 30% Bloomberg U.S. Aggregate Bond Index, 6% Bloomberg U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 24% S&P 500 Index, 10% Russell Midcap Index, 6% Russell 2000 Index, 8% MSCI EAFE Index, 7% MSCI Emerging Markets Index, 2% Bloomberg Commodity Index.

**Bloomberg Commodity Index** is comprised of 23 exchange-traded futures on physical commodities weighted to account for economic significance and market liquidity.

**Bloomberg U.S. Aggregate Bond Index** is a broad-based measure of the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market.

**Bloomberg U.S. Corporate High-Yield Bond Index** covers the U.S. dollar-denominated, non-investment grade, fixed-rate, taxable 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. Included issues must have at least one year until final maturity.

**Bloomberg U.S. Treasury Bills (1-3M) Index** is representative of money markets.

**JPMorgan EMBI Global Index** is a U.S. dollar-denominated, investible, market cap-weighted index representing a broad universe of emerging market sovereign and quasi-sovereign debt. While products in the asset class have become more diverse, focusing on both local currency and corporate issuance, there is currently no widely accepted aggregate index reflecting the broader opportunity set available, although the asset class is evolving. By using the same index provider as the one used in the developed-market bonds asset class, there is consistent categorization of countries among developed international bonds (ex. U.S.) and emerging market bonds.

**MSCI All Country World Index (ACWI)** is a free-float-adjusted market-capitalization-weighted index that is designed to measure the equity market performance of 23 developed and 23 emerging markets.

**MSCI EAFE Index (Europe, Australasia, Far East) Index** (MSCI EAFE) is a free float-adjusted market capitalization index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.

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