EXECUTIVE SUMMARY

The global equity markets have shown a fair degree of volatility over the last year. In the U.S., an abrupt market decline at the beginning of 2016 was followed by the surprise Brexit vote in the summer. Markets then rallied near the end of the year following the surprise Donald J. Trump presidential victory.

It’s no wonder investors are anxious about the market as we enter a period of some uncertainty. It could be tempting for investors to deviate from their long-term strategy at any sign of market weakness.

One approach for maintaining a consistent investment strategy with an appropriate level of risk involves periodically rebalancing a diversified portfolio. This involves shifting money on a regular basis from assets that have performed well to those that have been lagging. This strategy can reduce portfolio volatility, potentially provide some cushion in declining markets, and help minimize the emotional aspects of investing.

From the start, 2016 was full of surprises. The year began with the U.S. market’s first correction (a decline of at least 10%) since 2011. The market bounced back only to experience global panic following the Brexit vote in June 2016. While the decline was steep but short-lived, investors may have also been a bit panicked, questioning their investment strategy and if the time was ripe to make changes. As the market quickly recovered, the ensuing U.S. presidential election became front and center. While a Donald J. Trump victory was indeed a surprise, markets did not reel as expected, but rather showed resilience and ended the year on a strong note.

Eight years of a bull market may be good news for investors. But in reality, there’s a heightened level of anxiety where investors may overreact emotionally at the next sign of a market setback.

“We counsel investors all the time that you have to maintain a long-term perspective,” says Judith Ward, CFP®, a senior financial planner. “It’s important to remember the role that stocks and bonds play in a portfolio. Over long periods of time, stocks have outperformed other financial assets and provided a better hedge against inflation, while bonds have provided steady income and usually helped reduce portfolio volatility.

“We also encourage investors not to react to daily headlines and focus on what they can control, such as their asset allocation strategy and how much they save and spend,” she adds. “Diversifying broadly across and within asset classes is not a guarantee that you won’t lose money, but investors should maintain a diversified strategy that reflects their long-term goals and risk tolerance and that they can stick with during periods of short-term volatility, rather than bailing out of stocks and going to cash.”
A REBALANCING ACT

One approach for maintaining a consistent investment strategy with an appropriate level of risk involves periodically rebalancing a diversified portfolio. By shifting money among various asset classes to adhere to your long-term allocation targets, you can prevent your risk exposure from drifting higher when markets are performing well and potentially take advantage of stock market declines by investing at more attractive prices.

“When markets are performing well, investors tend to ride them higher,” Ms. Ward says. “But when there is a sharp decline, they could incur a significant loss. Rebalancing is a way to help maintain a level of risk that investors are comfortable with.”

Rebalancing may seem counterintuitive to some investors, she adds. “It’s sometimes difficult emotionally to trim the areas that have been doing well in favor of areas that have been under pressure. However, when you think about the rebalancing process, you’re actually selling high and buying low. It is a way to be more disciplined in your investment approach and minimize the emotional aspects of investing.”

Over the long term, rebalancing may or may not deliver significantly higher returns than a static buy-and-hold strategy, where portfolio allocations are allowed to drift, but it can reduce portfolio volatility and potentially cut losses during a downturn, enabling investors to weather the inevitable market setbacks.

“When you have a smoother ride,” Ms. Ward explains, “you’re more likely to stay invested. That’s important because investors who are able to stay the course can come out ahead, while those whose portfolios encounter extreme volatility tend to buy and sell at the wrong time. As a result, they often fall short of meeting their financial objectives.”

Rebalancing is inherently linked to diversification, notes Stefan Hubrich, a director of the firm’s asset allocation research. “A non-rebalanced portfolio can become undiversified over time, as it becomes more concentrated in the assets with the highest prior performance,” Mr. Hubrich points out. “For example, in a strong momentum-driven market, the portfolio’s weighting in stocks could grow dramatically. So rebalancing is a way to make sure you remain diversified, and that may provide a better risk-adjusted return over time.”

REBALANCING IN PRACTICE

For a clearer picture of the long-term benefits of rebalancing, consider the performance of a hypothetical portfolio assuming an initial $100,000 investment on December 31, 1996, in a balanced portfolio of 60% equities (42% U.S. large- and small-cap stocks and 18% developed international stocks) and 40% U.S. investment-grade bonds. In one scenario, the portfolio is never rebalanced; in the other two scenarios, the portfolio is rebalanced quarterly and rebalanced annually to maintain the original target asset allocation.

Our research has consistently shown that the rebalanced portfolios could have achieved roughly the same or even better return as a non-rebalanced portfolio and, over longer periods, at a lower level of risk as measured by the standard deviation of returns.1 Additionally, the annually rebalanced portfolio had more consistent and better results than one that is rebalanced quarterly (see Figures 1 and 2 below).

WEATHERING THE UPS AND DOWNS

When looking closer at pivotal market events, the annually rebalanced portfolio helped preserve capital during two major bear markets over the past 20 years—the technology bubble and the global financial crisis.

THE TECHNOLOGY BUBBLE

From the beginning of the 20-year period through the latter half of the 1990s, the U.S. stock market consistently racked up double-digit gains.

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1Standard deviation is a measure of volatility that indicates the range of possible outcomes for a portfolio—positive or negative—over a given period of time. The higher the standard deviation, the greater the volatility or market risk.
The hypothetical non-rebalanced portfolio would have benefited significantly from its growing equity exposure at the peak of the bull market in the early 2000s.

As the U.S. market fell precipitously over the next three years, however, the non-rebalanced portfolio would have experienced a larger loss (22%) than the annually rebalanced portfolio (19%) at the trough of the bear market in late 2002, as shown in Figure 3.

**THE FINANCIAL CRISIS**

After the deep 2000–2002 bear market, stocks rebounded strongly in the ensuing bull market. By November 2007, the rebalanced portfolio would have recovered its losses and hit a new high as compared with the non-rebalanced portfolio.

Of course, the 2002–2007 bull market was followed by the 2008 global financial crisis and another bear market of historic intensity. While both portfolios would have suffered significant setbacks, maintaining a consistent equity allocation would have helped mitigate the steep decline (see Figure 4).

Over the entire 20-year period covered by our analysis, the rebalanced portfolio edged the non-rebalanced portfolio with an annualized return of 6.87% versus 6.45%, respectively. Additionally, the rebalanced portfolio exhibited less volatility and suffered less capital erosion in the two bear markets (see Figure 5).

**FIGURE 3: Performance Before/After Technology Bubble**

<table>
<thead>
<tr>
<th>Hypothetical Non-rebalanced Portfolio</th>
<th>Hypothetical Annually Rebalanced Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>12/31/96</td>
<td>12/31/00</td>
</tr>
<tr>
<td>$100,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>40%</td>
<td>40%</td>
</tr>
<tr>
<td>60%</td>
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<td>$159,830</td>
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</tr>
<tr>
<td>$126,660</td>
<td>$129,460</td>
</tr>
<tr>
<td>51%</td>
<td>51%</td>
</tr>
</tbody>
</table>

**FIGURE 4: Performance Before/After Financial Crisis**

<table>
<thead>
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<th>Hypothetical Non-rebalanced Portfolio</th>
<th>Hypothetical Annually Rebalanced Portfolio</th>
</tr>
</thead>
<tbody>
<tr>
<td>10/31/07</td>
<td>2/28/09</td>
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<td>$230,330</td>
<td>$153,910</td>
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<td>67%</td>
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<td>33%</td>
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<td>$349,020</td>
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<td>47%</td>
<td>45%</td>
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<tr>
<td>$377,510</td>
<td>$163,670</td>
</tr>
<tr>
<td>60%</td>
<td>55%</td>
</tr>
</tbody>
</table>

**FIGURE 5: Impact of Rebalancing on Investment Performance**

January 1997–December 2016

The chart compares the growth in value of an initial $100,000 portfolio invested on January 1, 1997, composed of 60% stocks and 40% bonds. One portfolio is rebalanced annually to maintain the original asset allocation, and the other is not rebalanced at all. The rebalanced portfolio declined less in bear markets, was less volatile over the entire 20-year period, and outperformed the non-rebalanced portfolio.

The initial asset allocation for all hypothetical portfolios was composed of 36% large-cap U.S. stocks (Russell 1000 Index), 6% small-cap stocks (Russell 2000 Index), 18% international stocks (MSCI EAFE Index), and 40% U.S. investment-grade bonds (Bloomberg Barclays U.S. Aggregate Bond Index).

Source: T. Rowe Price.
ANNUAL REVIEWS
Since the asset mix in a portfolio constantly changes in line with market performance, Ms. Ward advises investors to review their asset allocations at least annually and evaluate whether they are comfortable with their overall risk exposure.

Keep in mind, though, that while rebalancing a portfolio in a tax-deferred account such as an IRA or 401(k) plan has no immediate tax implications, selling within a taxable account may result in taxable capital gains. To avoid the tax consequences of rebalancing, investors can also reach their desired mix by allocating new investments to underweighted asset classes to help bring the portfolio back in line.

Another approach that reduces portfolio turnover is to rebalance at the end of the year only if one of the asset classes has strayed by a certain amount (three to five percentage points, for example) from the allocation target. Whatever the approach, keep in mind that rebalancing does not protect against loss in a declining market.

REBALANCING SERVICES
Many IRA service providers (including T. Rowe Price) and workplace deferred contribution plans may offer rebalancing services. This may be a convenient way for investors to maintain a target allocation through changing market conditions.

For investors who want the convenience of a one-stop, broadly diversified portfolio, where exposure to different asset classes is maintained within certain guidelines, T. Rowe Price also offers various asset allocation funds. These funds provide professional management of the asset allocation process, broad diversification within asset classes, and regular rebalancing of assets.

T. Rowe Price’s asset allocation funds do not attempt to “time the market” by making aggressive bets on which asset classes will perform best over the short term. Instead, they tend to make gradual and modest tactical shifts, within certain ranges, to the targeted asset allocation, taking into account the investment outlook and relative valuations of different market sectors. The asset class and sub-asset class weightings are overseen by the firm’s Asset Allocation Committee, which includes a number of seasoned investment managers.

One of the most important aspects of T. Rowe Price’s asset allocation funds is that they help investors stay focused on their investment goals through changing market conditions and maintain a consistent risk profile.

The type of asset allocation fund that best suits you could depend on how much control and flexibility you want in determining your asset allocation and risk tolerance, depending on your financial goals and time horizon.
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