Rebalancing Portfolios in a Bear Market

Key takeaways

• Large market moves, as we’ve experienced recently, can significantly alter a portfolio’s risk/reward profile and impact how quickly a portfolio may recover from a drawdown. We believe now is a good time for investors to consider reviewing their portfolios for opportunities to rebalance.

• Rebalancing a portfolio to strategic asset allocation targets is an important component of an investment strategy that can help investors achieve their long-term goals.

What it may mean for investors

• The need for investors to rebalance portfolios may increase as they approach their investment goals or time horizon. Investors also are encouraged to revisit investment goals during a portfolio checkup to determine whether their investment objectives, time horizon, and risk tolerance have changed.

Buy low and sell high is a strategy that many investors strive to follow. But following this strategy can be challenging in volatile markets, when many asset prices—particularly stocks—are reacting to headlines related to the coronavirus pandemic. A change in economic conditions or large market moves, upward or downward, can significantly alter a portfolio’s risk/reward profile. That’s why we believe now is a good time for investors to consider reviewing the positioning of their portfolios. Rebalancing—taking profits and reallocating into assets that have underperformed—is an important component of an investment strategy that can help investors achieve their long-term goals.1

1 Keep in mind, liquidating holdings could have tax consequences. Wells Fargo Investment Institute and its affiliates are not tax or legal advisors.
Chart 1 illustrates the potential effect that rebalancing would have had on a hypothetical 60% stocks/40% bonds portfolio during full market cycles. In view of the significant sell off, it demonstrates why now may be a good time to consider rebalancing, especially if this has not been done recently.

Prior to the start of the current bear market, stocks had experienced a record-long bull market. Without rebalancing since March 2009—the start of the bull market—a 60% stocks/40% bonds portfolio would have drifted to be 84% stocks/16% bonds by February 19, 2020.

This overexposure to equities drastically changed the risk profile of the intended allocation, leaving the portfolio even more at risk for the sharp downturn. This portfolio that was allowed to drift has since started to drift toward bonds, ending March with an 81% stocks/19% bonds mix. Based on our analysis, using a disciplined rebalancing approach, the hypothetical portfolio is able to achieve a return similar to the portfolio that was allowed to drift, but the volatility of the rebalanced portfolio is significantly lower over this time period, which includes both a bull and part of a bear market.²

**Chart 1. Investors should consider rebalancing portfolios to help manage risk**

Sources: Morningstar Direct, Wells Fargo Investment Institute; March 31, 2020. 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. Current market cycle illustrations are for the period March 9, 2009 to March 31, 2020 with starting allocation of 60% stocks and 40% bonds on March 9, 2009. Previous market cycle illustrations are for the period October 9, 2002 to March 9, 2009 with starting allocation of 60% stocks and 40% bonds on October 9, 2002. 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. Hypothetical and past performance does not guarantee future results.

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 greater the risk.

© 2020 Wells Fargo Investment Institute. All rights reserved.
A similar pattern is evident looking at the previous market cycle (bottom of Chart 1) including the bull market from October 2002 through October 2007 and the bear market from October 2007 through March 2009. During that market cycle, which included part of the "lost decade" for U.S. stocks, the hypothetical rebalanced portfolio had a higher return and lower volatility than the non-rebalanced portfolio. At the end of the bull market, the portfolio allowed to drift had an over-allocation to equities of 72% vs. the intended 60%. By the time the bear ended, the portfolio was over-allocated to bonds. An over-allocation to equities can leave a portfolio more at risk than may be intended during a downturn, while an over-allocation to bonds at the end of the bear market can reduce return potential, which leaves the portfolio more at risk for a longer recovery time.

We recognize that rebalancing a portfolio can be an emotional undertaking for some investors, but rebalancing during a bear market is crucial as it allows an investor to purchase stocks for lower prices as prices fall. Allowing the portfolio to drift during a bear market is likely to result in a higher allocation to fixed income than intended, as portfolio allocations drift from strategic targets and an investor's desired risk level. This could impact the time it takes for a portfolio to recover once the bear market is over.

For example, a hypothetical 60% stocks/40% bonds portfolio rebalancing quarterly recovered two months earlier than a portfolio allowed to drift after the previous bear market (10/9/2007–3/9/2009). Additionally, a more balanced, diversified allocation like Moderate Growth & Income, rebalanced quarterly, recovered seven months sooner than a quarterly rebalanced 60% stocks/40% bonds allocation and five months ahead of its non-rebalanced counterpart.

Table 1. Recovering from bear markets

<table>
<thead>
<tr>
<th>Months to recover after 2007–2009 bear market</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>60% S&amp;P 500 Total Return Index/40% Bloomberg Barclays U.S. Aggregate Bond Index (rebalanced quarterly)</td>
<td>36</td>
</tr>
<tr>
<td>60% S&amp;P 500 Total Return Index/40% Bloomberg Barclays U.S. Aggregate Bond Index (no rebalancing)</td>
<td>38</td>
</tr>
<tr>
<td>Hypothetical Moderate Growth and Income 4AG portfolio without PC (rebalanced quarterly)</td>
<td>29</td>
</tr>
<tr>
<td>Hypothetical Moderate Growth and Income 4AG portfolio without PC (no rebalancing)</td>
<td>34</td>
</tr>
</tbody>
</table>

Sources: Morningstar Direct, Wells Fargo Investment Institute; March 31, 2020. 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. 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. 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. Moderate Growth and Income Four Asset Group model portfolio without private capital: 3% Bloomberg Barclays U.S. Treasury Bills 1–3 Month Index, 16% Bloomberg Barclays U.S. Aggregate Bond Index (5–7 Year), 6% Bloomberg Barclays U.S. Aggregate Bond Index (10+ Year), 6% Bloomberg Barclays U.S. Corporate High Yield Bond Index, 5% JPM EMBI Global Index, 20% S&P 500 Index, 10% Russell Mid Cap Index, 8% Russell 2000 Index, 6% MSCI EAFE Index, 5% MSCI Emerging Markets Index, 3% HFRI Relative Value Index, 6% HFRI Macro Index, 4% HFRI Event Driven Index, 2% HFRI Equity Hedge Index.
Is it time for a portfolio checkup?

Once an asset allocation has been selected, we believe that a “set it and forget it” mindset is unlikely to work effectively in today’s markets, especially as volatility ramps up. To help keep a portfolio on track, we believe that investors should consult their investment professional and review its positioning, at least annually, to determine whether it needs any adjustments and/or rebalancing.

During a bear market, we believe investors should focus on reallocating to those asset classes that tend to sell off the most during a drawdown. In our view, by rebalancing in this manner and bringing a portfolio’s risk profile back to the desired level, investors are more likely to stick to their plans, endure market downturns, and be better positioned to work toward their long-term goals. Rebalancing does involve realizing gains, which could have tax consequences. Investors should consult a tax professional and an investment professional to develop a tax and rebalancing strategy that works for their unique circumstances. Investors also are encouraged to revisit short-term and long-term goals during a portfolio checkup to determine whether investment objectives, time horizon, and risk tolerance may be evolving.
Risks Considerations

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.

Alternative investments, such as hedge funds, private equity/private debt and private real estate funds, are speculative and involve a high degree of risk that is suitable only for those investors who have the financial sophistication and expertise to evaluate the merits and risks of an investment in a fund and for which the fund does not represent a complete investment program. They entail significant risks that can include losses due to leveraging or other speculative investment practices, lack of liquidity, volatility of returns, restrictions on transferring interests in a fund, potential lack of diversification, absence and/or delay of information regarding valuations and pricing, complex tax structures and delays in tax reporting, less regulation and higher fees than mutual funds. Hedge fund, private equity, private debt and private real estate fund investing involves other material risks including capital loss and the loss of the entire amount invested. A fund’s offering documents should be carefully reviewed prior to investing.

Hedge fund strategies, such as Equity Hedge, Event Driven, Macro and Relative Value, may expose investors to the risks associated with the use of short selling, leverage, derivatives and arbitrage methodologies. Short sales involve leverage and theoretically unlimited loss potential since the market price of securities sold short may continuously increase. The use of leverage in a portfolio varies by strategy. Leverage can significantly increase return potential but create greater risk of loss. Derivatives generally have implied leverage which can magnify volatility and may entail other risks such as market, interest rate, credit, counterparty and management risks. Arbitrage strategies expose a fund to the risk that the anticipated arbitrage opportunities will not develop as anticipated, resulting in potentially reduced returns or losses to the fund.

Definitions

An index is unmanaged and not available for direct investment.

**Investment Grade Fixed Income:** 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.

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

**Bloomberg Barclays U.S. Aggregate 10+ Year Bond Index** is composed of the Barclays U.S. Government/Credit Index and the 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.

**High Yield Fixed Income:** Bloomberg Barclays 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.

**Cash Alternatives/Treasury bills:** Bloomberg Barclays U.S. Treasury Bill (1-3 Month) Index is representative of money markets.

**Commodities:** Bloomberg Commodity Index is a broadly diversified index of commodity futures on 20 physical commodities, subdivided into energy, U.S. agriculture, livestock, precious metals, and industrial metals sectors. Commodity weights are derived in a manner that attempts to fairly represent the importance of a diversified group of commodities to the world economy.

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

**Hedge Funds:** HFRI Fund Weighted Index is a fund-weighted (equal-weighted) index designed to measure the total returns (net of fees) of the approximately 2,000 hedge funds that comprise the index. Constituent funds must have either $50 million under management or a track record of greater than 12 months. Substrategies include: HFRI Event Driven, Distressed/Restructuring Index, and HFRI Event Driven (Total) Index.

**Developed Market Ex-U.S. Fixed Income:** JP Morgan Global Ex U.S. Index (JPM GBI Global Ex-U.S.) is a total return, market-capitalization-weighted index, rebalanced monthly, consisting of the following countries: Australia, Germany, Spain, Belgium, Italy, Sweden, Canada, Japan, the United Kingdom, Denmark, the Netherlands, and France.

**Emerging Market Fixed Income:** JPM 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.

**Developed Market Ex-U.S. Equities:** MSCI EAFE Index (Europe, Australasia, Far East) Index is a free-float-adjusted market-capitalization-weighted index designed to measure the equity market performance of developed markets, excluding the U.S. and Canada.
**Emerging Market Equities:** The MSCI Emerging Markets Index is a free-float-adjusted market-capitalization-weighted index designed to measure equity market performance of emerging markets. MSCI makes no express or implied warranties or representations and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices or any securities or financial products. This report is not approved, reviewed, or produced by MSCI.

**U.S. Small Cap Equities:** 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.

**U.S. Mid Cap Equities:** The Russell Midcap Index measures the performance of the 800 smallest companies in the Russell 1000 Index, which represent approximately 25% of the total market capitalization of the Russell 1000 Index.

**U.S. Large Cap Equities:** The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market-value-weighted index with each stock’s weight in the index proportionate to its market value.

**Inflation-CPI:** The IA SBBI U.S. Inflation Index is a custom unmanaged index designed to track the U.S. inflation rate.

**HFRI Relative Value Index** maintains 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, and other security types.

**HFRI Event Driven Index** maintains 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, and other capital structure adjustments. Security types can range from most senior in the capital structure to most junior or subordinated and frequently involve additional derivative securities. Event driven exposure includes a combination of sensitivities to equity markets, credit markets, and idiosyncratic, company-specific developments. Investment theses are typically predicated on fundamental characteristics (as opposed to quantitative) with the realization of the thesis predicated on a specific development exogenous to the existing capital structure.

While the HFRI Indexes are frequently used, they have limitations (some of which are typical of other widely used Indexes). These limitations include survivorship bias (the returns of the Indexes may not be representative of all the hedge funds in the universe because of the tendency of lower performing funds to leave the index); heterogeneity (not all hedge funds are alike or comparable to one another, and the index may not accurately reflect the performance of a described style); and limited data (many hedge funds do not report to Indexes, and, therefore, the index may omit funds, the inclusion of which might significantly affect the performance shown. The HFRI Indexes 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 HFRI Asset Management, L.L.C. Results for funds that go out of business are included in the index until the date that they cease operations. Therefore, these Indexes may not be complete or accurate representations of the hedge fund universe, and may be biased in several ways. Returns of the underlying hedge funds are net of fees and are denominated in USD.

**NOTE:** The 4 asset group without private capital Moderate Growth and Income Portfolio represents a balanced portfolio. A balanced portfolio composed of a variety of asset classes typically does not exhibit the same level of volatility as an individual asset class. This helps to smooth out portfolio performance over time.

**General Disclosures**

Global Investment Strategy (GIS) is a division of Wells Fargo Investment Institute, Inc. (WFII). WFII is a registered investment adviser and wholly owned subsidiary of Wells Fargo Bank, N.A., a bank affiliate of Wells Fargo Bank & Company.

The information in this report was prepared by Global Investment Strategy. Opinions represent GIS’ opinion as of the date of this report and are for general information purposes only and are not intended to predict or guarantee the future performance of any individual security, market sector or the markets generally. GIS does not undertake to advise you of any change in its opinions or the information contained in this report. Wells Fargo & Company affiliates may issue reports or have opinions that are inconsistent with, and reach different conclusions from, this report.

The information contained herein constitutes general information and is not directed to, designed for, or individually tailored to, any particular investor or potential investor. This report is not intended to be a client-specific suitability analysis or recommendation, an offer to participate in any investment, or a recommendation to buy, hold or sell securities. Do not use this
report as the sole basis for investment decisions. Do not select an asset class or investment product based on performance alone. Consider all relevant information, including your existing portfolio, investment objectives, risk tolerance, liquidity needs and investment time horizon.

Wells Fargo Advisors is registered with the U.S. Securities and Exchange Commission and the Financial Industry Regulatory Authority, but is not licensed or registered with any financial services regulatory authority outside of the U.S. Non-U.S. residents who maintain U.S.-based financial services account(s) with Wells Fargo Advisors may not be afforded certain protections conferred by legislation and regulations in their country of residence in respect of any investments, investment transactions or communications made with Wells Fargo Advisors.

Wells Fargo Advisors is a trade name used by Wells Fargo Clearing Services, LLC and Wells Fargo Advisors Financial Network, LLC, Members SIPC, separate registered broker-dealers and non-bank affiliates of Wells Fargo & Company. CAR 0420-01161