Rebalancing: The diversification defense

How rebalancing can help your portfolio weather volatility

Watching your portfolio's returns go up and down can be an emotionally trying experience. Rebalancing to a predetermined, diversified asset mix makes it so you don't have to worry about market instability as much. When you maintain the appropriate asset allocation, it can serve as a buffer against extreme swings in the market. As a result, you can feel more confident about your portfolio's ability to potentially preserve value in turbulent markets.

The chart below illustrates the point. Looking to the rightmost column of the chart, clearly the 60% stock, 40% bond (60/40) portfolio does not provide the highest long-term return. But over time, it emerges as being among the top few outperformers.

More consistency through balance

Annual returns by asset class, from the highest to the lowest, 2002–2021

'02	'03	'04	'05	'06	'07	'08	'09	'10	'11
Comm. 25.9%	EM equities 58.8%	REITs 31.6%	EM equities 32.9%	REITs 35.1%	EM equities 39.4%	Global bonds 5.8%	EM equities 78.5%	REITs 28.0%	REITs 8.3%
U.S. bonds 10.3%	Global stocks 40.4%	EM equities 26.7%	Comm. 17.5%	EM equities 29.9%	Global stocks 15.9%	U.S. bonds 5.2%	Global stocks 40.4%	EM equities 18.9%	U.S. bonds 7.9%
Global bonds 6.8%	REITs 37.1%	Global stocks 20.9%	Global stocks 15.8%	Global stocks 26.9%	Comm. 11.1%	Cash 1.8%	U.S. equities 28.8%	U.S. equities 17.3%	Global bonds 3.9%
REITs 3.8%	U.S. equities 31.6%	U.S. equities 12.6%	REITs 12.2%	U.S. equities 15.7%	60/40 8.3%	60/40 –22.1%	REITs 28.0%	Comm. 16.7%	U.S. equities 1.1%
Cash 1.7%	Comm. 22.7%	60/40 11.4%	60/40 7.3%	60/40 13.7%	U.S. bonds 7.0%	Comm. –36.6%	60/40 22.3%	60/40 11.0%	Cash 0.1%
EM equities –7.0%	60/40 22.5%	Comm. 7.6%	U.S. equities 6.1%	Cash 4.8%	U.S. equities 5.6%	U.S. equities –37.0%	Comm. 18.7%	Global stocks 10.7%	60/40 –0.4%
60/40 –7.5%	U.S. bonds 4.1%	Global bonds 5.3%	Global bonds 5.4%	U.S. bonds 4.3%	Cash 4.7%	REITs –37.7%	U.S. bonds 5.9%	U.S. bonds 6.6%	Comm. –13.4%
Global stocks –15.3%	Global bonds 2.4%	U.S. bonds 4.3%	Cash 3.0%	Global bonds 3.2%	Global bonds 4.3%	Global stocks –45.5%	Global bonds 4.4%	Global bonds 3.3%	Global stocks –14.3%
U.S. equities –20.9%	Cash 1.1%	Cash 1.2%	U.S. bonds 2.4%	Comm. –2.7%	REITs –15.7%	EM equities –53.3%	Cash 0.2%	Cash 0.1%	EM equities –18.4%

'12	'13	'14	'15	'16	'17	'18	'19	'20	'21	Avg.
EM equities 18.2%	U.S. equities 33.5%	REITs 30.1%	REITs 3.2%	U.S. equities 12.7%	EM equities 31.1%	Global bonds 3.2%	U.S. equities 30.8%	U.S. equities 21.0%	REITs 43.2%	EM equities 13.6%
REITs 18.1%	Global stocks 15.8%	U.S. equities 12.6%	Global bonds 1.3%	EM equities 11.8%	Global stocks 27.4%	Cash 1.9%	REITs 26.0%	EM equities 15.5%	Comm. 27.1%	REITs 12.7%
Global stocks 17.0%	60/40 15.4%	Global bonds 9.1%	U.S. bonds 0.4%	Comm. 11.4%	U.S. equities 21.2%	U.S. bonds –0.1%	Global stocks 21.8%	60/40 13.0%	U.S. equities 25.7%	U.S. equities 11.5%
U.S. equities 16.4%	REITs 2.5%	60/40 6.5%	U.S. equities 0.4%	REITs 8.5%	60/40 15.5%	REITs –4.6%	EM equities 20.4%	Global stocks 11.2%	60/40 10.7%	Global stocks 9.0%
60/40 12.0%	Global bonds 1.3%	U.S. bonds 5.9%	Cash 0.0%	60/40 7.1%	REITs 5.2%	60/40 –5.0%	60/40 19.8%	U.S. bonds 7.7%	Global stocks 8.8%	60/40 8.0%
Global bonds 6.5%	Cash 0.1%	EM equities 1.2%	60/40 –0.6%	Global bonds 4.9%	U.S. bonds 3.6%	U.S. equities –5.2%	U.S. bonds 8.9%	Global bonds 4.7%	EM equities 1.5%	U.S. bonds 4.4%
U.S. bonds 4.3%	U.S. bonds –2.0%	Cash 0.0%	Global stocks –4.3%	Global stocks 4.7%	Global bonds 2.6%	Comm. –13.0%	Global bonds 8.1%	Cash 0.6%	Cash 0.0%	Global bonds 4.2%
Cash 0.1%	EM equities –4.3%	Global stocks –3.4%	EM equities –15.4%	U.S. bonds 2.8%	Cash 0.8%	Global stocks –14.6%	Comm. 5.4%	Comm. –3.5%	U.S. bonds –1.6%	Comm. 2.2%
Comm. –1.1%	Comm. –9.6%	Comm. –17.0%	Comm. –24.7%	Cash 0.3%	Comm. 0.7%	EM equities –14.8%	Cash 2.3%	REITs –8.0%	Global bonds –2.1%	Cash 1.2%

U.S. equities | 60% equities/40% bonds | Cash investments | Global stocks | Global bonds
Reits | Emerging markets equities | U.S. bonds | Commodities

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.

Source: Vanguard, as of December 31, 2021.

Notes: Cash investments are represented by the FTSE 3-Month US T-Bill Index. U.S. equities are represented by the Dow Jones Wilshire 5000 Index through April 22, 2005; MSCI US Broad Market Index through June 2, 2013; and CRSP US Total Market Index thereafter. U.S. bonds are represented by the Bloomberg U.S. Aggregate Bond Index through December 31, 2009, and Bloomberg U.S. Aggregate Float Adjusted Index thereafter. Global stocks are represented by the Total International Composite Index through August 31, 2006; MSCI EAFE + Emerging Markets Index through December 15, 2010; MSCI ACWI ex USA IMI Index through June 2, 2013; and FTSE Global All Cap ex US Index thereafter. Global bonds are represented by the Bloomberg Global Aggregate ex-USD Index (USD Hedged) through December 31, 2012, and Bloomberg Global Aggregate ex-USD Float Adjusted RIC Capped Index (USD Hedged) thereafter. Emerging markes equities are represented by the Select Emerging Markets Index through August 23, 2006; MSCI Emerging Markets Index through January 9, 2013; FTSE Emerging Transition Index through June 27, 2013; FTSE Emerging Index through November 1, 2015; FTSE Emerging Markets All Cap China A Transition Index through September 18, 2016; and FTSE Emerging Markets All Cap China A Inclusion Index thereafter. Commodities are represented by the Bloomberg Commodity Index. REITs are represented by the FTSE NAREIT Equity REIT Index. Composite 60/40 portfolio's equity allocation consists of 60% U.S. stocks and 40% non-U.S. stocks, and bond allocation consists of 70% U.S. bonds and 30% non-U.S. bonds.

But something else very important is happening with that 60/40 portfolio. Historically, when the stock portion wasn't performing so well, the bond portion typically remained relatively stable (or might even have performed significantly better, depending on the period). This diversification benefit means that bonds may provide some cushion to your portfolio when the stock market hits a rough patch.

Indeed, you can notice in the chart that the 60/40 portfolio doesn't seem to bounce around as much—that is, exhibit as much volatility—as most of the other asset classes. Many investors feel it's worth it to accept lower returns in return for a reduced exposure to risk and instability, which helps them sleep better at night.

Let’s say you had two hypothetical portfolios, each consisting of 50% stocks and 50% bonds. One of them you rebalanced regularly. The other you allowed to “drift,” by not rebalancing. Over the course of 30 years, the rebalanced portfolio would have nearly 30% less median volatility than the untended one.[1] For people close to their financial goals or who just don’t like risk, this can be meaningful.

If you have questions, we can talk about your portfolio’s asset allocation and the rebalancing methodology we use to keep it on track.

1 Yan Zilbering, Colleen M. Jaconetti, and Francis M. Kinniry Jr., 2015. Best practices for portfolio rebalancing. Valley Forge, Pa.: The Vanguard Group.

Notes:

Please remember that all investments involve some risk. 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.

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