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Three Tools to Help You Cope With Market Volatility

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While the U.S. economy has been resilient and stocks have rallied in the last three years, global equity markets have been volatile, as investors seem to alternate frequently between a "risk on" and a "risk off" mentality. Given slowing economies in Europe and in emerging markets, especially China, and the potential for tighter U.S. fiscal policy (i.e., higher taxes and lower government spending) at the beginning of 2013, some investors may feel that stocks seem very risky or they may be fearful of a major pullback. But money market and bond yields remain very low and are mostly unattractive to investors looking for a safer alternative that still offers decent income or total return potential. In addition, some are concerned about the potential for substantial bond losses if interest rates rise to more normal levels. In this environment of heightened volatility and uncertainty, it's important to maintain an appropriate asset allocation and stay on course as you pursue your long-term financial goals. Portfolio rebalancing, broad diversification, and systematic investing are three tools that can help.

Asset Allocations Should Vary Based on Each Investor's Goals

Because each investor has his or her own financial goals, time horizon, and risk tolerance, there is no single asset allocation mix that is best for everyone. For example, an investor who plans to retire in 15 years may want to keep 75% of her retirement portfolio invested in stocks and 25% in bonds. She wants her portfolio to grow over time but has begun to reduce its potential for volatility because retirement is starting to get close. In contrast, a younger person who is just starting his career might want to keep at least 90% of his 401(k) assets in stocks and the rest in bonds because he has a longer time horizon.

Determining an appropriate asset allocation based on your goals, time horizon, and risk tolerance is critical to a successful investment program. Individuals who are able to invest for the long term can accept more short-term volatility in their portfolio and need not be as concerned with market fluctuations. However, those who know that a major financial need is imminent must be more focused on preserving the value of their investments and less on trying to generate more gains.

Three Tools That Can Help You Stay on Course

1. Portfolio Rebalancing.

Doing this on a regular basis is very important; T. Rowe Price financial planners suggest doing so at least once per year. It is a disciplined way of restoring your portfolio's asset allocation to the percentages that are appropriate for your goals, time horizon, and risk tolerance. This can also help you maintain a desired level of diversification among the different sub-asset classes represented in your portfolio.

By rebalancing, you:

- reduce exposure to areas of the market that have become too heavily weighted in your portfolio;
- avoid having too small an allocation to a market segment that, for example, has not been performing as well as other areas, thereby limiting your potential to benefit from a sector recovery; and
- maintain a disciplined approach to investing—which, we believe, is preferable to making reactionary changes based on responses to short-term market movements.

2. Broad Diversification. While it cannot assure a profit or protect a portfolio against loss, it can help reduce your exposure to poorly performing sectors in a given market environment. Therefore, even in situations when volatility is high and most areas of the market are suffering declines, investors with a well-diversified portfolio should fare better than those having a narrow investment focus.

Making investment decisions based on past performance or emotional responses to current conditions is likely to yield poor results. Therefore, it's important to maintain a broadly diversified portfolio to reduce downside risk and increase the likelihood of having exposure to some of the better-performing market segments, regardless of short-term swings in the market. After all, you never know which securities or asset classes will perform best—or worst.

Recent Performance of Key Asset Classes

The table below shows how several major asset classes performed in each of the last five calendar years. Each asset class has been given its own color so you can see how its performance ranking among these six asset classes shifted from year to year.

2007	2008	2009	2010	2011
Emerging markets stocks (39.78%)	Investment-grade U.S. bonds (5.24%)	Emerging markets stocks (79.02%)	Small-cap U.S. stocks (26.85%)	Investment-grade U.S. bonds (7.84%)
International stocks (11.63%)	High yield bonds (-26.17%)	High yield bonds (54.22%)	Emerging markets stocks (19.20%)	High yield bonds (5.47%)
Investment-grade U.S. bonds (6.97%)	Small-cap U.S. stocks (- 33.79%)	International stocks (32.46%)	Large-cap U.S. stocks (15.06%)	Large-cap U.S. stocks (2.11%)
Large-cap U.S. stocks (5.49%)	Large-cap U.S. stocks (- 37.00%)	Small-cap U.S. stocks (27.17%)	High yield bonds (14.42%)	Small-cap U.S. stocks (-4.18%)
High yield bonds (2.65%)	International stocks (- 43.06%)	Large-cap U.S. stocks (26.46%)	International stocks (8.21%)	International stocks (- 11.73%)
Small-cap U.S. stocks (-1.57%)	Emerging markets stocks (-53.18%)	Investment-grade U.S. bonds (5.93%)	Investment-grade U.S. bonds (6.54%)	Emerging markets stocks (-18.17%)

This chart is shown for illustrative purposes only and does not represent the performance of any specific security. It is not possible to invest directly in an index. *Past performance cannot guarantee future results.*

Large-cap U.S. stocks are represented by the S&P 500 Index, which measures the performance of 500 mostly large-cap U.S. companies. Small-cap U.S. stocks are represented by the Russell 2000 Index, which measures the performance of 2,000 small U.S. companies. Investing in small companies involves greater risk than is customarily associated with larger companies because small companies often have limited product lines, markets, or financial resources, and their managements may lack depth and experience.

International stocks are represented by the MSCI EAFE Index, which measures the performance of stocks in developed countries in Europe, Australasia, and the Far East. Emerging markets stocks are represented by the MSCI Emerging Markets Index, which measures the performance of stocks in more than 20 emerging market countries that may be traded by foreign investors. International investing involves unique risks, including currency fluctuation. Investments in emerging markets are subject to abrupt and severe price declines and should be regarded as speculative.

High yield bonds are represented by the Credit Suisse High Yield Index, which measures the performance of domestic, noninvestment-grade corporate bonds. Investment-grade U.S. bonds are measured by the Barclays U.S. Aggregate Bond Index, which measures the performance of domestic investment-grade taxable bonds, including corporate, government, and mortgage-backed securities. The yields and prices of bonds will fluctuate with interest rate changes. This is the decline in bond prices that usually accompanies a rise in interest rates. Companies issuing high yield bonds are not as strong financially as those with higher credit ratings, so the bonds are usually considered speculative investments.

Let's take a closer look at two of these asset classes:

Emerging markets stocks moved from one performance extreme to another. They outperformed most asset classes in 2007, 2009, and 2010. However, they fared worst in 2008 and 2011.

If a significant portion of your portfolio had been invested in emerging markets equities, you would have experienced significant volatility over the last five years, though it has subsided notably in the last two years.

If the losses in 2008 seemed unbearable, you might have been tempted to sell some or all of your holdings just before the market rallied in 2009.

However, if you had only a relatively small portion of your portfolio invested in emerging markets stocks, your losses in 2008 would have been smaller in dollar terms. Rather than panic and sell, you might have found those losses to be more manageable and decided to hang on long enough to enjoy the significant rebound in 2009 and 2010. While emerging markets' performance in 2011 was disappointing, many emerging countries have stronger fundamentals than developed economies, and we remain optimistic about their long-term prospects.

Investment-grade U.S. bonds experienced five years of moderate positive returns—the only featured asset class to do so. However, their performance ranking varied quite a bit.

After generating respectable gains in 2007, investment-grade bonds outperformed significantly in 2008. While the asset class lagged substantially in 2009 and 2010, it provided the best results in 2011.

The performance of investment-grade bonds in the last five years and their lower volatility relative to riskier asset classes underscore their value as a means to diversify a portfolio. Of course, the suitability of fixed income investments depends on the investor's time horizon and risk tolerance, and past performance cannot guarantee future results.

If you gave up on stocks and high yield bonds in favor of investment-grade debt after the horrific 2008 downturn, you would have still enjoyed some gains over the next few years. But you might have missed the more significant gains generated by riskier asset classes in 2009 and 2010.

But who knew in advance that investment-grade bonds would outperform in 2011 and produce a fifth consecutive year of gains? Because it is impossible to know what market segments will perform best or worst in any period, it is better to keep some of your assets in all or most major asset classes at all times than to try to time the markets.

3. Systematic Investing. Consistently investing toward a goal regardless of short-term market fluctuations can be a key to success for many investors. T. Rowe Price offers two systematic investing services that can help keep you on track: regularly scheduled exchanges between mutual funds and automatic purchases from a bank account or through payroll deduction.

When you invest a fixed amount on a regular basis, you are using dollar cost averaging—purchasing more shares of a stock or mutual fund when the price falls and fewer shares when the price rises. In a way, you are already using dollar cost averaging if you contribute to a 401(k) or other defined contribution retirement plan every time you get paid.

Dollar cost averaging cannot assure a profit or protect against loss in a declining market. Since such a plan involves continuous investment in securities regardless of fluctuating price levels, you should consider your financial ability to continue purchases through periods of both high and low price levels.