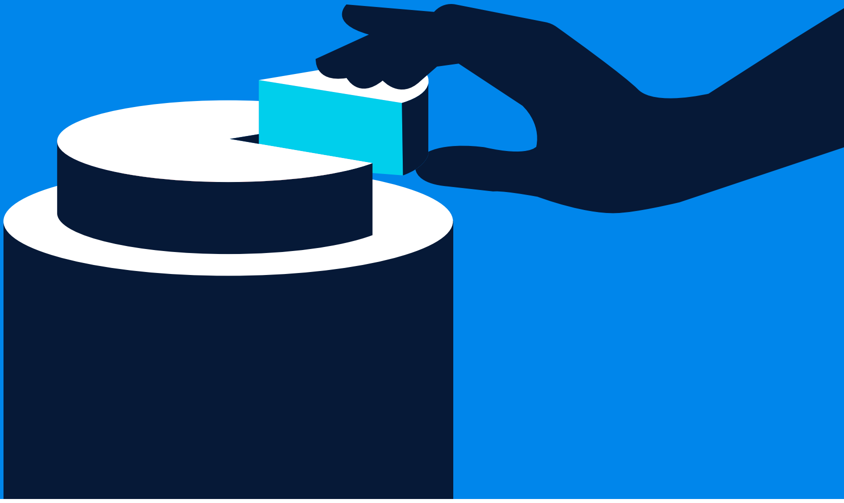
T. Rowe Price

Redeploying cash with asset allocation strategies



From the Field
May 2024

Key Insights

- With record cash on the sidelines, our recent analysis suggests that now might be a good time to redeploy cash back into the market.
- A high-quality asset allocation strategy deserves consideration when redeploying cash, and almost 50% of financial professionals in our database use an asset allocation strategy in their investment models.
- A key factor when evaluating asset allocation strategies is determining how much the strategy emphasizes strategic asset allocation versus tactical asset allocation.
- Integrating an asset allocation strategy into a model can be a straightforward process, based on a review and evaluation of historical asset weights of the strategy and funding sources.

Terry Davis
Director of Investment Solutions

Andrew Wick, CFA®
Lead Analyst, Portfolio Construction Solutions

One of the questions we're often asked by financial professionals is how and when to redeploy cash into the markets. To help answer this question, the T. Rowe Price Portfolio Construction team analyzed the average 12-month excess returns of representative indexes versus a cash proxy over the past four federal funds interest rate peaks (February 1995, May 2000, June 2006, and December 2018). We used the 90-day T-bill as a proxy for cash and cash equivalents, and we compared these returns with stocks (S&P 500 Index), bonds (Bloomberg U.S. Aggregate Bond Index), and a 60/40 portfolio containing a mix of stocks, bonds.

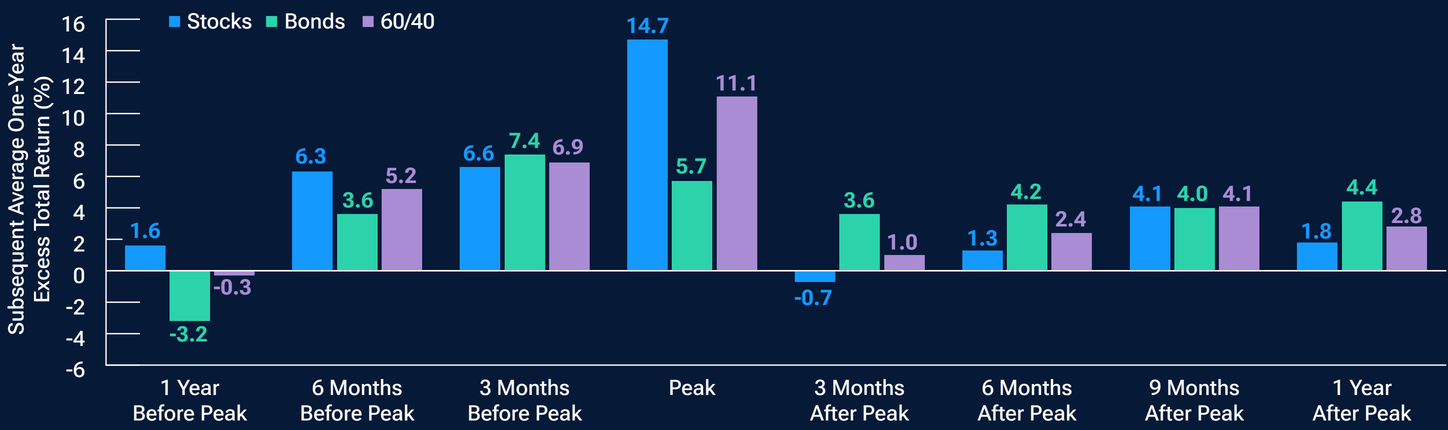
Our analysis focused on the impact of investing at various starting points prior to, at, and after the rate cycle peak. As shown in Figure 1, a typical 60/40 moderate-risk portfolio composed of 60% stocks and 40% bonds outperformed after a fed funds peak.

Why add an asset allocation strategy to a model?

Asset allocation strategies are designed to provide access to broad diversification in a single holding. They can help to keep down the number of model placements. They can also provide a

Deploying cash into a traditional 60/40 portfolio typically has been beneficial in most periods

(Fig. 1) Subsequent average one-year excess total return of stocks, bonds, and a 60/40 portfolio versus cash



Past performance is not a reliable indicator of future performance. For illustrative purposes only. This is not representative of actual investments and does not reflect any fees and expenses associated with investing. Indexes cannot be invested in directly.
Sources: Morningstar, Standard & Poor's, Bloomberg. Analysis by T. Rowe Price.
Cash proxy = 90-Day U.S. Treasury Bill. Stocks = S&P 500 Index. Bonds = Bloomberg U.S. Aggregate Bond Index. 60/40 portfolio was allocated 60% to the S&P 500 Index and 40% to the Bloomberg U.S. Aggregate Bond Index and reweighted monthly. This analysis covers the prior four Fed rate hike cycles. The current interest rate cycle is not included. Interest rate peaks = highest levels for the Federal Reserve federal funds interest rate.

stable foundation on which to build your model portfolios, allowing investors to use remaining allocations on more aggressive or less diversified positions. And finally, strategies that use a tactical asset allocation approach can add professionally managed tactical asset allocation to an investment model.

Do financial professionals use asset allocation strategies in their models? The short answer is yes. Figure 2 indicates that 48% of model portfolios reviewed by our Portfolio Construction Solutions team in 2023 used an asset allocation strategy, up from 43% in 2021. The most commonly deployed strategies fall in the moderate allocation category, followed by global allocation strategies. Figure 2 also shows that, when an allocation strategy is used in a moderate model, the average allocation is about 10%.

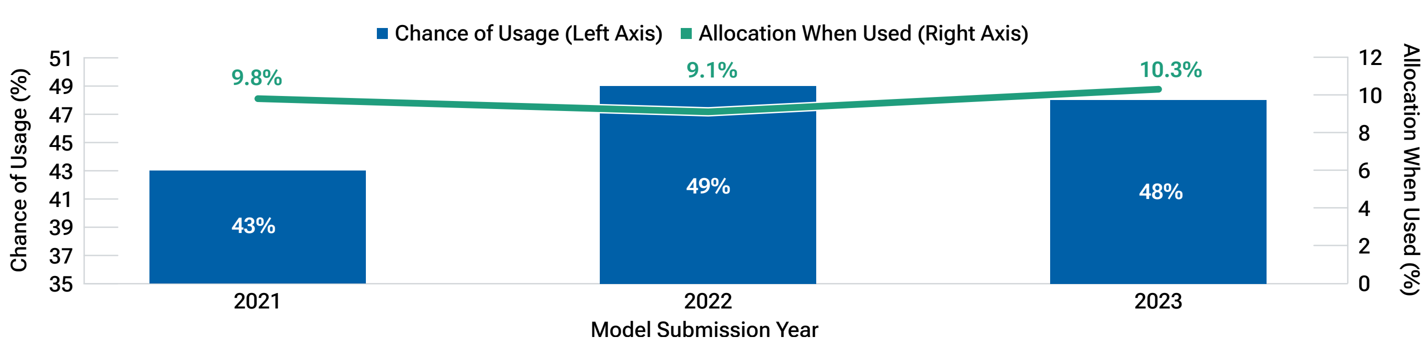
Not all asset allocation strategies are created equal

When evaluating asset allocation strategies, it's important to consider how much emphasis the strategy places on strategic asset allocation (SAA) versus tactical asset allocation (TAA). To simplify this point, we break allocation strategies into two categories. The first category typically provides a broadly diversified portfolio (SAA) in a single strategy with limited tactical overlays (TAA). Most balanced funds would fall into this category. The second category is more tactical in nature, and the holdings will deviate more than those in the first category.

How can an investor tell into which category an asset allocation strategy fits?

Nearly 50% of model portfolios used an asset allocation strategy, with an average allocation of about 10% when used in moderate models

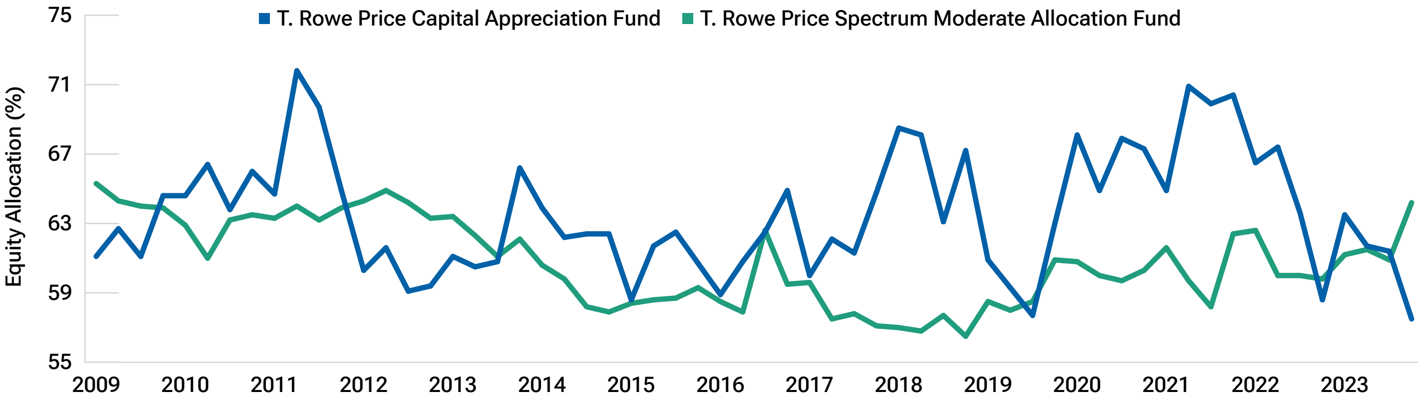
(Fig. 2) Asset allocation strategy usage and average allocation as of December 31, 2023



Source: T. Rowe Price Client Investment Platform database.

Different allocation strategies use different approaches, and allocations can vary significantly over time

(Fig. 3) Average equity allocations in two representative strategies, March 31, 2009–December 31, 2023



Source: T. Rowe Price.

First, read and understand the strategy's key documents, including the prospectus, fact sheet, etc. Second, look for differences over time when searching databases. For example, analyze equity and fixed income allocations over time. Figure 3 shows the equity weights of two T. Rowe Price asset allocation funds in the moderate allocation category: Capital Appreciation and Spectrum Moderate Allocation. You'll see that the Capital Appreciation fund's bottom-up investment process results in more tactical equity changes while Spectrum Moderate Allocation leans more heavily on SAA.

In addition, it may be valuable to look at a strategy's regional exposures, investment style, and market capitalization patterns for its equity allocation. For fixed income exposure, evaluate changes in duration and credit quality over time.

How to add an allocation strategy to a model

Adding an asset allocation strategy into a model requires looking at the historical weights of the strategy and evaluating funding sources. If you are redeploying cash, use an allocation strategy with a similar equity weight to the model's equity weight. If funding from other strategies, consider the steps below.

For simplicity, we use a 60/40 (equity/fixed income) asset allocation strategy with a 10% model allocation as an example.

- Calculate the strategy's average asset allocation weights, e.g., 60% equity or 20% international equity.

- It's critical to account for the equity and fixed income beta, a common measure of volatility. In this example, a 10% model allocation translates to 6% equity funding and 4% fixed income funding. To increase risk in the model, consider taking more allocation from fixed income; to decrease risk, take more allocation from equity.

- Next, assess U.S. and international allocations. If the strategy only has U.S. exposure, fund only from U.S. equity. If the strategy has a 30% international weighting, multiply the international percentage by the equity weight—in this case, 30% international strategy weight multiplied by 6% equity funding equals about 2%. So, fund 4% from U.S. equity and 2% from international equity.

- Perform similar assessments for investment style and market capitalization.

> " It's critical to account for the equity and fixed income beta, a common measure of volatility.

- For fixed income funding sources, pay particular attention to matching credit quality, duration, regional exposure, and correlations. For example, if the allocation fund has 50% in sub-investment grade, consider funding 2% from plus sector fixed income.

T. Rowe Price Portfolio Construction Solutions can help

If you're preparing to redeploy cash into the market or are thinking of adding an asset allocation strategy to your model, we can help. Supported by the multi-asset experience and global resources of T. Rowe Price, our integrated suite of Portfolio Construction Solutions is designed to address your portfolio construction needs and help position your practice for success.

Portfolio Construction Solutions from T. Rowe Price

We work with financial professionals to find practical solutions for critical investment and practice challenges. Used independently or in combination, each component of our integrated suite of Portfolio Construction Solutions provides access to T. Rowe Price's world-class multi-asset expertise and global investment resources to address your portfolio construction needs.

Art of Clean Up®	Model Construction	Asset Allocation Model Review	Portfolio Construction Insights
Consolidate	Build	Adjust	Inform

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Past performance cannot guarantee future results. All charts and tables are shown for illustrative purposes only.

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