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Rebalancing: A Better Strategy than Market Timing

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"The essence of investment management is the management of risks, not the management of returns." – Benjamin Graham

Executive Summary

Portfolio rebalancing is the process of adjusting your investments back to your target asset allocation. Over time, different assets (like stocks and bonds) will grow at different rates – for example, stocks might surge during a bull market while bonds grow slowly. This causes your portfolio's mix to "drift" away from the original plan. Rebalancing brings it back in line. The primary goal is risk management, not chasing higher returns. By rebalancing, you maintain the level of risk you intended and keep your portfolio aligned with your long-term goals. It's essentially a periodic tune-up for your investments to ensure you're not unintentionally taking on too much (or too little) risk.

Stick to Your Target Allocation to Manage Risk

Staying aligned with your target allocation is crucial because asset allocation is the major determinant of your portfolio's risk and return characteristics. If a portfolio is left alone, higher-risk assets (like stocks) can become overweight and push the portfolio's risk above your comfort zone. Rebalancing forces you to "sell high and buy low" – trimming back assets that have grown (potentially overpriced) and boosting those that have lagged (potentially good value). This discipline helps lower risk without significantly hurting returns. In fact, plenty of research shows that routinely rebalancing a portfolio is one of the simplest ways to reduce volatility while only marginally reducing long-term returns potential. The trade-off is giving up a bit of the upside in exchange for much better downside control.

Consider a simple example: You start with a 60% stocks / 40% bonds portfolio. If stocks have a great run, you might end up with, say, 70% in stocks and only 30% in bonds. That higher stock exposure means more risk than you initially signed up for. Rebalancing would prompt you to sell some stocks and/or buy bonds to get back to 60/40. This keeps your risk in check and locks in some stock gains. If you don't rebalance, your portfolio could become much more aggressive than intended, which is dangerous if a market downturn hits. One Vanguard study showed that a "drifting" 60/40 portfolio grew to about 75% stocks in just four years of a bull market, substantially increasing the risk by late 2007, just in time for the financial crisis and a dramatic decline in stock prices. Investors who failed to rebalance before the 2008 crash learned the hard way that higher exposure to stocks can mean much bigger losses. In short, rebalancing is about staying true to your risk tolerance and long-term plan, so you're not unwittingly betting the farm on yesterday's winners.

Common Rebalancing Strategies: Calendar vs. Threshold

There are two popular approaches to rebalancing: calendar-based strategies and threshold-based strategies. Both aim to get you back to your target mix, but they trigger rebalancing in different ways.

Calendar-Based Rebalancing

This method rebalances on a set schedule – for example, annually, semi-annually, or quarterly. Many investors choose an annual rebalance (say every January) or semi-annual (January and July). The idea is simply to pick a regular interval and adjust your holdings back to target at those times. The benefit of calendar rebalancing is its simplicity and consistency. You don't have to constantly watch your portfolio; you just check in at the set date and make changes if needed. Annual rebalancing is often sufficient to keep a portfolio's risk in line. In fact, the conventional wisdom is to rebalance about once a year – doing it more often yields little extra benefit in most cases. That said, some people rebalance quarterly or even monthly. The downside of very frequent (calendar) rebalancing is that you may be making unnecessary trades, incurring extra costs or taxes for minimal improvement in risk control. We'll see in the data below that rebalancing more than annually tends to have diminishing returns in terms of outcomes.

Threshold-Based Rebalancing

This approach (also called tolerance band rebalancing) doesn't wait for a set date – instead, you rebalance whenever your allocation drifts by more than a specified threshold. For example, you might choose a 5%

threshold, meaning if your stock allocation moves 5 percentage points above or below its target (e.g. your 60% stocks grows to over 65% or drops under 55%), that triggers a rebalance. Common trigger points are 5% or 10%. A 10% threshold is looser – using the same 60/40 example, you'd let stocks go up to 70% or down to 50% before rebalancing. Threshold rebalancing has the benefit of responding to market moves: it makes you rebalance after big swings, but won't bother with small fluctuations. This can be efficient – you're only trading when it's truly necessary to bring the portfolio back in line. In effect, threshold rules create a "buy low, sell high" discipline: when stocks have rallied so much that they're 5–10% over target, the rule forces you to sell some (locking in gains); when stocks have plunged and are far below target, it nudges you to buy more at cheap prices. The downside is that you must continually monitor your portfolio, because triggers can happen anytime (e.g. a market crash or spike in between your usual check-ins). Fortunately, many brokerage platforms and tools can alert you or automatically rebalance when thresholds are breached.

In practice, a hybrid approach is often recommended: *Periodic monitoring with threshold triggers*. For example, Vanguard's research suggests checking your portfolio annually or semiannually and rebalancing only if an allocation is off by more than 5%. Such a hybrid strategy strikes a good balance between risk control and cost minimization. If a year goes by and nothing is out of line, you simply do nothing. But if markets have swung your allocation beyond the 5% band, you rebalance back to target. This is a solid strategy that keeps your portfolio on track without micromanaging every minor market move.

How Different Rebalancing Frequencies Affect Performance and Risk (Historical Data)

Does it actually matter if you rebalance quarterly versus annually versus using a 5% threshold? Investors often wonder if there's an "optimal" rebalancing frequency that maximizes returns or minimizes volatility. Extensive historical data can help answer this. Researchers have analyzed portfolio performance over many decades (in some cases going back to 1926) to see how various rebalancing strategies compare. The key findings are both insightful and reassuring for the average investor:

Over long periods, the choice of rebalancing frequency has had only a minor impact on risk and return, as long as you rebalance at least occasionally. In other words, monthly, quarterly, or annual rebalancing all lead to very similar outcomes in the long run. What differs is mainly the number of transactions (and thus costs), not your end wealth.

A 60/40 portfolio rebalanced annually from 1926–2009 returned about 8.6% per year with an annual volatility (standard deviation) around 12%. If you rebalanced quarterly, the outcome was virtually the same (~8.6% return, ~12.2% volatility). Even rebalancing monthly yielded ~8.5% return and 12.1% volatility – essentially no improvement in risk-adjusted returns for all that extra tinkering. The risk/return profile was nearly identical across these frequencies. The main difference was in trading activity: monthly rebalancing led to over 1,000 adjustment events in that 84-year span, whereas annual rebalancing needed only ~83 events. In practice, those extra 1,000 trades simply "drove up transaction costs without boosting performance". This finding has been echoed by multiple studies (including Vanguard's and others): there is no single rebalancing frequency that consistently outperforms the others on a return or risk basis.

What about never rebalancing at all? Interesting enough, letting a 60/40 portfolio go untouched will, over many years, tilt it heavily toward stocks (since stocks historically outperform bonds). In the Vanguard 1926–2009 analysis, the 60/40 portfolio that was never rebalanced drifted to about 84% stocks on average. Not surprisingly, this unrebalanced portfolio earned a higher long-term return (about 9.1% CAGR) but at the cost of much higher volatility (~14.4% standard deviation). In essence, the do-nothing strategy eventually turned the portfolio into something much more aggressive than 60/40, which is why the return was higher (stocks had a good run over those decades) and the risk was far higher. Importantly, the periodically rebalanced portfolios delivered much better risk-adjusted returns – they achieved about 95% of the return for a fraction of the volatility. Rebalancing kept the risk in check. For example, the Sharpe ratio (return per unit of risk) was improved by regular rebalancing. Another dramatic difference was seen in drawdowns: the unrebalanced portfolio suffered a much deeper worst-case loss during bad market periods. Over ~150 years of data, a 60/40 with no rebalancing had an approximate -80% max drawdown, while the same portfolio rebalanced annually had about a -62% max drawdown. That worst-case (largely representing the Great Depression crash) illustrates how rebalancing helped preserve more capital by not letting the stock allocation get too overextended before the crash. In more modern times, think of the 2008 financial crisis: an un-rebalanced 60/40 might have been, say, 70/30 going into 2008, thus losing more in the stock crash than a true 60/40 would. Regular rebalancing ensures you “sell high” in the good times (so you have less at risk during the bad times).

It’s worth noting that if one asset class consistently outperforms (as U.S. stocks did versus bonds for much of the 20th century), a portfolio that never rebalances will indeed end up with a higher terminal value – but it does so by straying into a very different (riskier) allocation. For most individual investors, that extra return isn’t worth the wild ride. The Vanguard study put it plainly: the never-rebalanced portfolio had the highest return **“as a result of its rising level of stocks in an 83-year period in which stocks beat bonds – but its volatility also was much higher”. In contrast, the frequently rebalanced portfolios (e.g. monthly) had the lowest volatility and only a slightly lower return, **“without a big return give-up”. In other words, you didn’t sacrifice much profit by rebalancing yearly or quarterly, and you significantly tamed the risk. Meanwhile, hyper-frequent rebalancing (e.g. daily or weekly) gave no tangible benefit and would just churn your holdings. As one research note quipped, “more frequent rebalancing will on average have little impact on risk reduction, even less benefit for returns, and just racks up unnecessary costs”.

Bottom line: There is *no magic frequency* that maximizes performance – anything from quarterly to annual rebalancing will keep your portfolio’s risk in a similar ballpark. The key is that you do rebalance at least periodically. The exact timing (whether every 6 months or when a 5% threshold is hit) is less critical than the act of correcting course when your allocation has drifted meaningfully. Many experts simply recommend rebalancing on a schedule that is easy for you to stick to (such as every year on a set date, or every 6 months) unless big market moves demand action sooner. If you set a 5% band, you might go a couple years without any trades if markets are calm, and that’s fine too. The historical data suggests that failing to rebalance at all can eventually change your risk profile dramatically, but rebalancing too often provides very minimal additional benefit. Thus, a moderate strategy (annual or semiannual, or threshold-based with sensible bands) hits the sweet spot for most long-term investors.

Asset Allocation Examples: 60/40 vs. 80/20 vs. 50/50

Let's briefly examine how rebalancing plays out for different asset allocation targets. The principles remain the same, but the stakes (in terms of risk) are different. Generally, the more stock-heavy (aggressive) the portfolio, the more critical rebalancing becomes for risk control, because there's more volatility to start with and more chance for big swings.

- 60/40 (Balanced) Portfolio: We've used this classic balanced portfolio in many examples above. With 60% in equities and 40% in fixed income, the portfolio has a moderate risk level. If not rebalanced, a 60/40 will drift upward in equity exposure when stocks outperform. Over very long periods (many decades), a 60/40 could morph into an 80/20 or beyond, as we saw (it reached ~84/16 on average from 1926–2009). Rebalancing a 60/40 keeps it anchored. Historically, a rebalanced 60/40 portfolio delivered around a ~8–9% annual return (nominal) with much lower volatility than an all-stock portfolio. Many investors choose to rebalance a 60/40 yearly, which has proven sufficient to maintain roughly that risk/return profile. The key benefit is preventing the 60/40 from quietly turning into a riskier 70/30 or 80/20 portfolio during extended bull markets.
- 80/20 (Aggressive) Portfolio: This portfolio starts off with a high equity allocation (80% stocks, 20% bonds), so it's inherently more volatile. If left alone, an 80/20 in a prolonged stock boom could tilt towards nearly 100% stocks. (In practice, there's a ceiling – it can't exceed 100% stocks – but you might effectively become 90/10 or 95/5 after major equity gains). That means an aggressive portfolio can become even riskier than intended. For example, imagine an 80/20 portfolio at the start of 2009 (after a big market drop). Stocks then had a tremendous run from 2009–2019. If you never rebalanced, by the end of that run your portfolio could be, say, ~95% in stocks, essentially an all-stock portfolio going into the 2020 downturn. Rebalancing an 80/20 periodically forces you to take profits from stocks along the way, ensuring you don't end up accidentally taking 100% stock-level risk. It will slightly trim the very highest returns (since again, you're selling some winners), but it dramatically cuts the volatility and drawdowns. In fact, one study noted that a more aggressive or concentrated portfolio "may require more frequent rebalancing to maintain similar risk control", simply because its higher volatility can trigger larger drifts more often. So, an 80/20 investor might consider checking quarterly or using tighter bands (maybe a 5% threshold) to keep

things in range. The good news is, rebalancing an aggressive portfolio doesn't negate its aggressive nature – an 80/20 will still earn higher returns than a 60/40 over the long run (historically an 80/20 returned roughly 1–2% per year more than 60/40 over many decades), but rebalancing makes sure those extra returns come with the intended level of risk, not an ever-increasing level of risk.

- 50/50 (Conservative) Portfolio: With half stocks and half bonds, a 50/50 is less volatile to begin with. If stocks greatly outperform for a while, a 50/50 might drift to 60/40 or 65/35 – still moderate, but riskier than the investor planned for a conservative allocation. Rebalancing pulls it back to 50/50, locking in equity gains and bolstering the fixed-income cushion. Conversely, if stocks tank and the portfolio becomes, say, 40/60, rebalancing will push it back up to 50% in stocks – buying low when equities are cheap. In terms of performance, a rebalanced 50/50 historically earned a bit less than a 60/40 (since it has less equity), but with lower volatility. For example, over the long run a 50/50 portfolio might have returned around ~7–8% annually (versus ~8–9% for 60/40) with noticeably smaller swings. The role of rebalancing here is to minimize "risk creep." Even though 50/50 is on the conservative side, failing to rebalance could leave you with a 60/40 or 70/30 after a big bull market, which is not what a conservative investor signed up for. Thus, a 50/50 should also be rebalanced occasionally to stay true to its low-risk objective. The flip side is that in a long bear market for stocks, a 50/50 that's not rebalanced would become even more heavily weighted in bonds (say 30/70), potentially missing the eventual stock recovery. Rebalancing ensures the portfolio will participate in the recovery by buying stocks when they're down.

In summary, whatever your target allocation – be it 80/20, 60/40, 50/50 or anything else – rebalancing keeps your portfolio's risk and return profile consistent with your plan. Aggressive portfolios have more volatile swings and thus can drift farther, but the principle is the same. Importantly, investors with very aggressive or very concentrated portfolios should be extra diligent with rebalancing, because there's less of a safety net if things become unbalanced. Meanwhile, very conservative portfolios (like 30/70) may not need to rebalance quite as often, since the low-volatility assets dominate – but they should still rebalance when equities move the needle significantly, to capture the rebound potential and maintain some growth exposure.

Costs and Tax Implications of Rebalancing

While rebalancing is clearly beneficial for risk management, it isn't free. Transaction costs and taxes are important practical considerations, especially for individual investors. When devising your rebalancing strategy, you should balance the benefits of rebalancing against these costs:

- Trading Costs: In the past, commissions and trading fees were a major deterrent to frequent rebalancing. These days, many brokers offer $0 commissions on stocks and ETFs, so transaction costs are much lower for many investors. However, costs haven't disappeared entirely. There can be bid-ask spreads, slippage, or fees if you're trading less liquid funds. If you trade mutual funds, some have short-term redemption fees. And if you use an advisor or platform that charges per trade, those fees add up. The research we discussed implicitly assumed no trading costs. In real life, unnecessary trades will detract from returns. If you rebalance very frequently, those small costs can compound. Therefore, cost control argues for a "light touch" on rebalancing if you face commissions or fees. For most investors on modern platforms, doing a few trades a year has negligible direct cost – but doing a few every week might start to hurt. Keep an eye on any fees, and if you're paying commissions, lean toward rebalancing less often (e.g. annually rather than quarterly).
- Tax Considerations: Taxes are often the biggest rebalancing cost. If you're rebalancing in a taxable account, selling a winner that's gone up in value will likely realize capital gains, which can trigger a tax bill. Rebalancing "peels back" your winners, and if those winners have appreciated, you owe taxes on those gains when you sell. For example, suppose you need to sell some stock funds that have doubled in order to rebalance – you'd be realizing a 100% gain on that portion, and if it's a taxable account, you'll owe capital gains tax (15% long-term for many investors, or more if short-term or higher tax bracket). This tax drag can significantly reduce the benefit of rebalancing if done too frequently. Tax-sheltered accounts, on the other hand, are ideal for rebalancing. If you rebalance inside a 401(k) or IRA, there are no immediate tax consequences – you can trade as needed without tax impact. Ditto for things like Roth IRAs (no taxes ever on gains) or 529 plans. Because of this, a common tactic is to rebalance with tax-advantaged accounts whenever possible. For instance, if you hold both taxable and IRA accounts with similar assets, you can do more frequent adjustments within the IRA to correct your overall allocation, while avoiding selling in the taxable account. In taxable accounts, "erring on the side of less-frequent rebalancing" is usually wise. Perhaps rebalance once a year or when absolutely necessary, rather than quarterly, if it's going to trigger taxable gains. Another tip: use cash flows

to rebalance instead of selling. Direct new contributions (or reinvest dividends) into the underweight asset class, and/or withdraw from the overweight asset when you need cash. This way you minimize capital gain realizations. In fact, Vanguard researchers found that **sweeping portfolio income (dividends, interest) into the lagging asset class achieved most of the risk-control benefit of rebalancing with much lower tax cost*. This is a very tax-efficient method – essentially, you are rebalancing incrementally, with money that's coming in, rather than by selling. Of course, not everyone has large contributions or dividends relative to portfolio size, so periodically you still may need to sell something. But whenever possible, do the bulk of rebalancing "maintenance" via contributions and withdrawals instead of taxable sales.

- Avoiding Short-Term Gains: If you *do* need to sell in a taxable account to rebalance, try to use lots that qualify for long-term capital gains (held >1 year) to benefit from lower tax rates. Also, consider timing – for example, rebalance in January instead of December if that lets some recent purchases cross the 1-year mark. Little timing choices can reduce the tax hit. And remember, you don't *have* to rebalance all at once. If you're way off target but sitting on big gains, you could rebalance gradually to spread the tax impact over a couple of tax years, or only partway to target to avoid pushing yourself into a higher tax bracket. These are more advanced maneuvers, but the general point is: be tax-aware. In taxable accounts, every rebalance trade should be evaluated through the lens of "does the risk reduction justify the tax cost I'm about to incur?"
- Rebalancing in Tax-Deferred Accounts: In tax-deferred or tax-exempt accounts (Traditional IRA, Roth IRA, 401k, etc.), you have free rein to rebalance whenever needed, since trades inside these accounts don't generate taxable events. If all your investments are tax-sheltered, you can focus solely on the investment considerations (risk, drift, etc.) and ignore tax impact. This is why institutions (like endowments or pension funds) rebalance very frequently – they don't pay taxes, so it's just a matter of trading costs and their desired risk control. For individual investors, tax-advantaged accounts are the best place to do frequent rebalancing. You might, for example, do small monthly or quarterly rebalances within your 401(k), while doing only annual tweaks in your taxable brokerage account.
- Time and Effort: While not a direct monetary cost, the time commitment and potential for error is a factor. Rebalancing more often means more time spent monitoring your portfolio and executing trades. Some investors enjoy this; others find it burdensome or stressful. If you have

multiple accounts and asset classes, rebalancing can get fiddly. Less-frequent rebalancing (e.g. once a year) is simpler and can reduce the temptation to tinker constantly. Remember, each time you check your portfolio, you might also be tempted to make other changes (like chasing a hot fund or changing your strategy), which can be counterproductive. Sticking to a set rebalancing plan helps avoid emotional or impulsive decisions. As Christine Benz humorously notes, if you're prone to "periodic anxious thought" about your portfolio, it's perfectly fine to rebalance only annually and otherwise leave it alone. On the other hand, if you're very engaged, have the time, and won't incur extra costs, a somewhat more hands-on approach (say quarterly) can be okay – just ensure it's systematic.

Putting it all together on costs/taxes: For most individual investors, an annual or semiannual rebalancing schedule hits a nice balance – it limits taxable events and trading costs, yet keeps your allocation from straying too far. If you hold mostly taxable accounts, lean toward less frequent rebalancing and use new cash flows to adjust. If you have substantial tax-advantaged assets, do the bulk of rebalancing there to avoid taxable sales. Always be mindful of the tax implications before hitting "sell." The goal is to maintain your portfolio's risk profile while minimizing drag from taxes and costs. Rebalancing is valuable, but beyond a certain point, doing it more often yields diminishing benefits and increasing costs. Each investor should find a rebalancing strategy that keeps them within their risk comfort zone *and* makes sense given their personal tax and cost situation.

Key Takeaways for Practical Portfolio Rebalancing

- Rebalancing is essential for managing risk. It realigns your portfolio to your intended asset mix, preventing unintended risk creep. This keeps your investments aligned with your long-term goals and risk tolerance.
- Various rebalancing strategies work similarly well over the long run. Whether you rebalance annually, quarterly, or via a 5% threshold, the long-term performance and volatility outcomes have been very similar in historical studies. There is *no single "best" frequency* that maximizes returns – more frequent rebalancing does not consistently improve results.
- Don't rebalance too often – it can increase costs and taxes without much benefit. More frequent adjustments (e.g. monthly) tended to raise

portfolio turnover significantly, “racking up costs” with no material gain in return or risk reduction. For most investors, once or twice a year is plenty. Check in periodically, but avoid obsessive tinkering.

- Consider a threshold-based or hybrid approach. Rather than rebalancing on a strict calendar regardless of market moves, many experts suggest combining methods: review periodically (say every 6–12 months) and rebalance only if the allocation is off by more than ~5%. This 5% tolerance band approach has been shown to provide a good balance between maintaining discipline and minimizing trading. It effectively filters out small, insignificant deviations while responding to big market swings.

- Rebalancing improves risk-adjusted returns by taming volatility and drawdowns. A rebalanced portfolio typically has a higher Sharpe ratio (better return for the risk taken) than an unrebalanced one. You give up a little upside in roaring bull markets, but you avoid extreme overweight in the asset that could crash next. Historically, the worst losses were significantly smaller for portfolios that were rebalanced versus those left to drift.

- Multiple asset mixes all benefit from rebalancing. Whether you’re 80/20, 60/40, or 50/50, the process keeps your portfolio true to its intended character. Aggressive portfolios can drift to even higher equity exposure (rebalance to prevent excess risk), and conservative portfolios can drift too conservative after a stock slump (rebalance to ensure you capture the recovery). In all cases, it’s about staying on the path you set, not what the market’s short-term movements dictate.

- Use tax-advantaged accounts and cash flows to rebalance whenever possible. This minimizes taxable gains. In taxable accounts, be strategic: rebalance less frequently, harvest losses to offset gains when you can, and redirect dividends/new contributions toward underweight assets. Remember that in an IRA/401k, you can rebalance without tax worries, so take advantage of that for fine-tuning your overall allocation.

- Rebalancing is not about boosting returns – it’s about controlling risk. It’s often said (and shown by research) that the benefit of rebalancing is chiefly risk reduction, not return enhancement. You’re unlikely to “beat” a buy-and-hold strategy in a straight return sense unless the market is mean-reverting. Instead, think of rebalancing as your tool to maintain the risk/reward profile you signed up for. It helps you avoid nasty surprises and emotional reactions when markets get turbulent.

- Stay disciplined, but also be practical. The best rebalancing plan is one you can stick to. Set up rules or reminders for whatever schedule/threshold you choose. Automate it if possible (many 401k plans allow automatic rebalancing). At the same time, don't let rebalancing become an obsession – it's there to serve your plan, not complicate it. If checking quarterly makes you uneasy, do it annually. If you have a taxable account with huge gains, it's okay to rebalance more gradually. The exact method can be tailored to your preferences as long as the core principle is honored: periodically nudge your portfolio back to target.

In conclusion, portfolio rebalancing is a fundamental practice for long-term investors to manage risk and stay aligned with their goals. It enforces the classic disciplined behavior of buying low and selling high, and it keeps your asset allocation – the driver of your portfolio's success – intact over time. Historical evidence since 1926 shows that while rebalancing won't magically boost your returns, it will keep your journey smoother and more predictable by averting extreme imbalances. The key is to rebalance in a way that's regular enough to control risk but not so frequent that costs and taxes overwhelm the benefits. For most individuals, rebalancing roughly once a year (or when things get 5–10% off target) in tax-advantaged accounts is a sound, low-maintenance strategy. By doing so, you'll ensure that your portfolio continues to work for you as intended – through bull markets and bear markets alike – keeping you on track toward your long-term financial objectives.

Sources: Long-term historical data and findings are based on studies by Vanguard and others, using U.S. stock and bond returns dating back to 1926. These studies include *"Best Practices for Portfolio Rebalancing"* (Jaconetti, Kinniry, Zilbering) and analyses summarized by Morningstar's Christine Benz. They demonstrate the risk/return outcomes of different rebalancing methods and inform the recommendations above. Always consider your personal situation (taxes, costs, time horizon) when applying these principles to your own portfolio. Rebalancing is a valuable tool – used wisely, it will help you invest confidently through market ups and downs.

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