RIGHTPATH™
Investments & Financial Planning, Inc.

Rebalancing Act

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Systematic Portfolio Rebalancing May Be the only "Free Lunch" in Investment Management

The recipe for successful investing includes a variety of ingredients: knowing your goals, choosing the right investments, discipline and even luck. The most important ingredient, however, is a well thought out and articulated investment policy, which is a fancy term for strategy. Why embody your strategy in an investment policy? Quite simply to reduce the errors that we are all prone to when we make ad hoc investment decisions—spur-of-the-moment moves made out of the larger context of other investment goals and holdings.

In fact, these errors are so common they have spawned a new discipline known as behavioral finance (see right). By establishing in advance, in a cool and rational manner, what criteria we will use in making future investment decisions, we become far less susceptible to sales pitches, market manias and other irrational influences.

Behavioral Finance

Recency bias is an excellent example of emotional, rather than logical, behaviors that drive investing practices. Recency bias is the result of expecting asset classes that have outperformed most recently to have higher expected future returns than other classes. In fact, the opposite generally is more likely to be true. Acting on that bias often results in impulsive deviation from an investment policy statement—and poorer returns.

To learn more, visit "Emotions of Investing" under "Who We Are" at www.rightpathinvestments.com.

Portfolio rebalancing may well be key to implementing your investment policy. While this concept can apply to your larger portfolio—including a closely held business, personal real estate and concentrated positions—let's focus on the impact of rebalancing on an investment portfolio.

Your investment policy will set your asset allocation, which is the percentage of your portfolio you will hold in the various asset classes, such as stocks and bonds, and sub-classes, such as large-cap stocks, small-cap stocks and international stocks. A rebalancing policy determines in advance under what conditions and in what manner you will return your portfolio to its original strategic asset allocation. But, if you have determined your asset allocation in advance and invested accordingly, why do you need to rebalance at all?

Balancing Ever-Changing Asset Values

Investors employ rebalancing for a variety reasons and use different factors to trigger action:

- Performance-driven rebalancing maintains a predetermined asset allocation by adjusting for the differing performance of different holdings.
- Time-driven rebalancing is triggered by regular intervals (weekly, monthly, etc.).

- Investors who “let it ride” do not rebalance at all.

We will focus on performance-driven rebalancing, by which the investor sells outperforming assets to purchase underperforming assets, thereby restoring the portfolio to its original asset allocation. For example, if your investment policy calls for an asset allocation of 60% equities and 40% bonds, you might plan to rebalance when you reached a 70/30 or 50/50 allocation. Similarly, if your equity portfolio called for 70% large cap and 30% small cap, you would rebalance when that ratio changes outside a predetermined limit.

Performance-driven rebalancing is often recommended for two reasons. First, asset class returns are expected to experience a so-called reversion to the mean—after a period of returns above the long-term expected rate of return (mean) they should produce returns below the mean in the future and vice-versa. Adopting this approach builds in a “buy low, sell high” discipline to your strategy. Second, this type of rebalancing introduces a substantial risk reducing benefit: it retains your predetermined diversification, reversing concentration in out-performers caused by market forces.

To Rebalance or Not to Rebalance: An Example

	Annual Rebalancing	No Rebalancing
Time Frame	1991–2000	1991–2000
Start Stock/Bond Allocation	60%/40%	60%/40%
End Stock/Bond Allocation	60%/40%	81%/19%
Compounded Annual Return	13.85%	14.45%
Standard Deviation (risk)	10.0%	11.9%

Example uses the S&P 500 Index and the Lehman Brothers Aggregate Bond Index.

Numerous studies demonstrate the benefits of rebalancing using historical data. Because not every portfolio scenario can be replicated, the persuasiveness of these studies depends on their assumptions: the number of asset classes and the initial mix, relative returns and correlations, the rebalancing interval, the evaluation interval and the addition of transaction costs. Here is one example.

The investor who did not rebalance did better—through 2000. But, the S&P 500 lost 11.9% of its value in 2001 and 22.1% of its value in 2002; at the same time, the Bond Index gained 8.4% 2001 and 10.26% in 2002. With 81% in equities, the investor who did not rebalance would have taken a significant hit by the losses in equities and would have missed out on the gains in fixed income holdings.

It takes strong dedication to an investment policy to rebalance money from equities to bonds during a bull market but, in this example, the investor who did exactly that would have captured most of the returns and been spared much of the pain of the tech bubble.

A recent study published in the Journal of Financial Planning titled "Does Portfolio Rebalancing Help Investors Avoid Common Mistakes?"* confirmed the benefits of disciplined rebalancing versus what the authors call the "chase portfolio" for a variety of scenarios for the period from 1926–2003.

"Tripping Points" and How to Sidestep Them

Rebalancing appears to have the greatest impact in volatile markets and is most effective when the preset tolerance bands are wide enough to breathe but narrow enough to present buy/sell opportunities. And, the more broadly diversified and uncorrelated the assets in the portfolio, the greater the rebalancing impact.

Effective rebalancing also requires diligent monitoring of portfolios, which investors often are reluctant to undertake. Yet, many financial planners and the services they use to monitor portfolios automatically provide clients with sophisticated, built-in rebalancing processes, allowing investors who work with planners to virtually forget about this crucial practice until an investment policy change is needed.

Investors must also be mindful of the tax consequences and take advantage of tax loss harvesting to shelter gains required to be realized when selling positions that have risen—another technique that can be greatly simplified through a relationship with an up-to-date financial planner.

The Take-Home Lesson

Establishing and maintaining an investment policy that includes rebalancing criteria typically provides greater returns and reduced risk. The practice goes a long way toward eliminating common investment pitfalls and may well support an investor in reaching well-defined goals. While these practices require a significant amount of discipline—both emotionally, in terms of sticking to the strategy, and technically, in terms of staying on top of the rebalancing process—the benefits appear clear and convincing. And, with savvy advisers making these services virtually automatic, there is little additional effort required on the part of the investor. Who says there's no such thing as a free lunch?

* *Source: Financial Planning Association, http://www.fpanet.org/journal/articles/2005_Issues/jfp0505-art6.cfm.*