



“Disciplined” Rebalancing Keeps Your Portfolio in Check

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An old adage is that in bull markets everyone is an investor and in bear markets everyone is a trader. It goes a long way in explaining the psychology of investing, or the difference between rational decisions and how investors actually behave.

When the economy is strong and the markets are moving higher, investors project this trend out indefinitely. The result is often a portfolio that is out of balance with their long-term plan and one that is taking on more risk than appropriate. They let their winners ride and trim the underperformers. Little thought is given to the role the underperformers may play in a properly diversified portfolio, thus increasing risk.

When the economy is weak and the markets are moving lower, this is also projected out indefinitely. Investors react to daily headlines and turn into traders who are focused on the present and not on the future. Emotions and fear override rational thought processes. The result is often a portfolio that is taking on less risk than appropriate, especially for long-term portfolios.

Implementing a disciplined process of portfolio rebalancing is one method for removing emotion from the decision making process. When equities dramatically outperform fixed income, rebalancing involves selling equities and reinvesting the proceeds into fixed income. This can be difficult as a “fear of regret” can be triggered in which an investor is more concerned with losing out on further portfolio gains from equities than from acknowledging that they are taking on a disproportionate amount of risk within the portfolio.

Disciplined rebalancing in an up market forces an investor to sell high and prevents riding the winners too long. Conversely, when equities dramatically underperform fixed income, rebalancing involves selling fixed income investments and reinvesting the proceeds into equities.

After the experiences of 2008, it is easy to understand why rebalancing is a much more difficult decision to implement. When the S&P 500 lost over a third of its value in 2008 and half of its value since late 2007, the thought of buying more equities in the midst of the worst bear market most of us have ever lived through would have made some investors sick to their stomachs. As the adage states, everyone is a trader on the way down. But if one truly wants to be an investor, with a long-term focus, rebalancing a portfolio is exactly what one should do. Disciplined rebalancing in a down market forces a process of buying low.

Example of Portfolio Returns

Consider a simple example of a portfolio invested 50% in equities and 50% in fixed income at the beginning of 2008. Given the -37% return of the S&P 500 and 5.2% return of the Barclays Aggregate Index, the portfolio would have returned -15.9%. The weighting of equities and fixed income would now be 37% and 63%, respectively. The portfolio would be disproportionately more conservative entering 2009. Assuming the portfolio went unbalanced and using S&P 500 and Barclays Aggregate returns through the end of September 2009, the portfolio would have returned 10.8% for the year. The weightings would now be 40% equities and 60% fixed income. Overall return would be -6.8%.

A disciplined approach to portfolio rebalancing would call for the sale of the fixed income investments and the purchase of more equities to return the portfolio back to a 50% - 50% weighting. If the portfolio was rebalanced at the end of 2008, the return for 2009 would have been 12.5% with equities consisting of 53% of the portfolio and fixed income 47%. Overall return of the rebalanced portfolio would be -5.4%. Rebalancing the portfolio to a proper asset allocation would have generated an additional 1.4% in returns while maintaining the appropriate risk level for the investor.

Of course this is a simplified example. Some common sense should be applied even to a disciplined approach. While market timing is difficult to predict, and impossible to do consistently, it helps to understand where the market is and the general direction it is heading.

Rebalancing while equities are still falling does more harm than good. This is where having a short-term tactical view on an asset class is important. Taxable investors, especially those in the highest tax brackets, should consider the implications of triggering a taxable event. Harvesting tax losses, while rebalancing, can produce higher after-tax returns in the future. Transaction costs and the illiquidity of certain investments will preclude re-balancing in certain circumstances. An investor's tolerance for risk also changes as their investment time horizon and liquidity needs change.

Maintaining a commitment to a long-term investment approach, one that includes disciplined rebalancing, is one way to avoid the risk aversion we all felt after the market declines experienced in 2007 and 2008.

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