

Keeping Your Portfolio in Check: A Disciplined Approach to Rebalancing

An old adage is that at market tops everyone is an investor and at market bottoms 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 a long-term plan and one that is taking on more risk than appropriate. They let their “winners ride.” When the economy is weak and the markets are moving lower, this is also projected out indefinitely. Investors turn into traders who are focused on the present and not on the future. 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, re-balancing 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 more risk within the portfolio. Disciplined re-balancing in an up market forces a process of “selling high.”

Conversely, when equities dramatically underperform fixed income, rebalancing involves selling fixed income investment and reinvesting the proceeds into equities. After the experiences in 2008, it is easy to understand why this is 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 this terrible bear market can make some investors sick to their stomach. As the adage states, everyone is a trader. 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.”

Consider a simple example of a portfolio consisting of 50% in equities and 50% in fixed income. Assume that in 2008 the equities lost half of its value while the fixed income portion retained all of its value. The return of the portfolio would have been negative 25%. The portfolio would consist of 33% in equities and 66% in fixed income. In order for the portfolio to return to its initial value, the equities would need to double.

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. In order for the portfolio to return to its initial value, the equities would only need to increase by 66.7% instead of the 100% return if the portfolio went unbalanced.

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 tactical view on an asset class that covers the near term is important. Taxable investors, especially those in the highest tax brackets, should consider the implications that may be caused by triggering a taxable event. Harvesting tax losses while rebalancing can produce higher after-tax returns in the future. Transaction costs and the illiquidity with certain investments will preclude re-balancing on a frequent basis. An investor’s tolerance for risk also changes as their investment time horizon grows shorter.

The “snake bite,” or risk aversion, one feels after experiencing the losses sustained over the past 18 months is natural. Maintaining commitment to a long-term investment approach, that includes disciplined rebalancing back into equities, is one way to overcome this aversion.

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