



Rebalancing Revisited: Keeping Portfolios on Track During Volatile Markets

By Elaine Floyd, CFP®

When the markets are quiet, rebalancing strategies often get pushed to the back of the portfolio management toolbox -- to be taken out and looked at every now and then, but generally not pressed into service. When the markets jump, however, rebalancing becomes an issue. With its well-defined rules and unemotional approach to portfolio management, the rebalancing tool can be of great comfort to clients, especially during periods of headline-making volatility. Whether it gets used or not, it lends an air of calm to the investment process and helps balance the one-sided messages clients are getting on the nightly news.

With the Dow making triple-digit moves and conflicting reports causing confusion about the economy, this may be a good time to review rebalancing strategies.

The first question to ask is: does rebalancing really work? The theory behind it, of course, is that restoring target allocations periodically keeps a portfolio from getting too far overweighted in any particular asset class. Reversion to the mean is a potential hazard for any asset class that has had a good run, so it's best to lighten up before the pullback occurs. Equally important is a way to get back in so you don't miss the next move. Compared to a strategy of market timing which requires you to be right twice, rebalancing simply allows you to take some money off the table for a while but essentially remain invested in a variety of asset classes.

In a paper titled "[Systematic Rebalancing: Overcoming Human Nature](#)," Alliance Bernstein compared two portfolios of \$100,000 each during the period 1990 through 2006. At the start, each portfolio was divided equally between growth and value stocks. During the 16-year period, which saw a boom in growth stocks in the 1990s followed by a recovery in value stocks starting in 2000, one portfolio was rebalanced to maintain the 50/50 allocation while the other was allowed to run. At the end, the un-rebalanced portfolio had only 35% exposure to growth stocks and was worth \$519,000 compared to \$555,000 for the rebalanced portfolio. More important, the rebalanced portfolio saw much less volatility; while both portfolios peaked in 2000, the un-rebalanced portfolio peaked at \$680,000 and saw a subsequent low of \$266,000, while the rebalanced portfolio peaked at \$624,000 and dipped to just \$292,000.

The next question to ask is how to do it? Rebalancing mandates that target allocations be restored periodically; beyond that, there are many theories about how it should be



done. Here are some popular strategies noted in "[The Art of Rebalancing](#)" by Smith Barney's Consulting Group:

- **Periodic rebalancing** is done according to a fixed schedule, such as annually, quarterly, or monthly. This has the advantage of simplicity.
- **Threshold rebalancing** is done when an asset class deviates from its target allocation by more than a certain amount, say 5%. So if the target allocation for stocks is 60% and the allocation reaches 67%, enough stocks would be sold to bring the allocation back to 60%.
- **Range rebalancing** is similar to threshold rebalancing but instead of restoring an asset class back to the target allocation, it is brought back to the maximum -- 65% in the example above.
- **Volatility-based rebalancing** is done when volatility rises above a certain predetermined threshold. Higher-volatility asset classes are sold and lower-volatility asset classes are purchased. For example, if small-cap stocks become excessively volatile, they would be sold and a lower-volatility asset class, such as short-term bonds, would be purchased.
- **Active rebalancing** takes into account expected market conditions when restoring allocations and adjusts them accordingly. It is similar to tactical asset allocation but is more conservative than market timing because changes in the portfolio tend to be relatively modest.

It is only natural, if you are selling off part of an asset class after it has made a strong run, to consider reducing the allocation at the same time. This is what David Beckwith, chief investment officer of RINET Company, LLC, did in the spring of 2007 when he lowered the allocation to small-cap international developed stocks after a period of prolonged outperformance. Not only had the asset class made a considerable move, but Beckwith saw a "flight to quality" theme beginning to play out based on economic fundamentals. So he rebalanced the small-cap foreign stock allocation and reduced it at the same time. His allocation to emerging markets, on the other hand, remained the same. Despite its strong performance, he felt that much of the asset class, particularly the large-cap stocks within the emerging markets universe, fit with the quality theme so he simply rebalanced portfolios back to the targeted 5% allocation. RINET manages about \$1.5 billion for about 120 high-net worth clients. Due to the relatively small number of clients, the firm is able to closely monitor portfolios so that rebalancing decisions are being made all the time, even if actual adjustments are not necessary.

Robert Kresek, who manages about \$600 million for 75 clients at Founders Financial notes that during the recent market turmoil most asset classes moved together, so that clients' portfolios stayed fairly well balanced. His main job has been communicating with clients. "There's a tendency for clients to panic," he says. "Our role is to bring some



perspective, to let them know that this is normal and that if we stick to the long-term plan, they'll be better off."

For many of Kresek's clients, rebalancing is handled with normal cash flow activities. As new money comes in through client contributions or interest or dividend income, the underweighted asset class is purchased. When distributions are made, the overweighted asset class is sold. When rebalancing involves repositioning the portfolio by selling one asset class and buying another, Kresek pays attention to the tax impact and tries to do the transactions in the client's tax-deferred account wherever possible. Transaction costs are also an important consideration.

The trend toward allocating assets to alternative investments, such as hedge funds and hard assets, is loosening rebalancing methodologies somewhat, partly because some of these assets are illiquid and can't be rebalanced. They may also play a balancing role on their own. "Hedge funds have the ability to benefit from anomalies in the market," says Beckwith. "You don't need to force any larger top down reshuffling when there is a lot of flexibility contained within the disciplines that you're hiring out to be managed."

Although the advantage of rebalancing is that it provides a non-emotional, rules-based methodology for restoring target allocations, it also lends itself to customization when investment considerations, the economic outlook, and client concerns warrant a tweaking of this valuable portfolio management tool.

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