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*The Benefits of Rebalancing*

Rebalancing is the process of adjusting an investment portfolio's composition to maintain a desired asset mix. It is used primarily to control portfolio risk. Rebalancing also serves to increase investment returns by selling high and buying low since, by definition, it requires selling an appreciated asset class and buying a depreciated (undervalued) asset class. Disciplined rebalancing helps investors avoid two expensive alternatives: drifting asset allocations and ill-timed changes in asset allocation.

Rebalancing might best be illustrated by an example: On January 1, 1998 an investor builds a portfolio with a long-term target allocation of 50% stocks and 50% bonds. By the end of 1999, assuming no rebalancing has taken place, her portfolio's allocation has drifted to 60% stocks and 40% bonds due to the divergent performance of those asset classes (S&P 500 and Lehman Aggregate Bond Index, in this example). For a conservative investor, this shift in asset mix may be unacceptable. The investor's greater exposure to stocks and lower exposure to bonds now results in a portfolio that is riskier than initially intended. Rebalancing would dictate selling 10% of the stock allocation and reinvesting it in the bond allocation, effectively re-aligning the asset weights back to the initial 50/50 target.

The alternative to rebalancing is, quite simply, to do nothing. A buy-and-hold investor purchases an initial portfolio and, regardless of whether the market is up or down, never alters that mix. In a rising market, the portfolio's exposure to stocks increases and declines in a falling market. While the cheapest strategy (no transaction costs are incurred) and also the most tax-efficient (nothing is sold), it can expose the investor to dramatic shifts in the risk profile of the portfolio.

Unfortunately, average investors pursue neither a buy-and-hold strategy nor one based on disciplined rebalancing. Human nature compels them to believe what has worked well in the past will continue to work well in the future. Investors crave comfort, yet the markets rarely reward it. Accordingly, the majority of investors *added* to their stock positions in 1999, further increasing the portion of risky assets in the portfolio. These same investors then liquidated significant portions of their portfolios in 2002, preferring the perceived safety of bonds and cash to stocks after the damage had already been done. Not surprisingly, ad-hoc moves such as these impose enormous costs on a portfolio over time, actually destroying value. Successful investors resist, at whatever the cost, the pressure to engage in such moves. They stay the course.

Rob Arnott, editor of the *Financial Analysts Journal*, looked at the effects of various rebalancing strategies over the years 1973-1988. His findings suggested disciplined rebalancing produced an average return of 9.82% for a 60% stock, 40% bond portfolio. A buy-and-hold strategy (with no rebalancing) produced results that lagged the rebalancing strategy by 16 basis points per year. Ad-hoc shifts, such as the ones made by most investors in 1999 and 2002, reduced return by 39 basis points per year, on average.

Using Mr. Arnott's findings, a \$1 million 60/40 portfolio invested in 1973 would have grown to \$4.1 million by the end of 1988. The buy-and-hold (drifting mix) and ad-hoc portfolios would have fallen short by \$100,000 and \$200,000, respectively. Lest the significance of this shortfall be overlooked, consider its impact on the \$180 billion California Public Employees' Retirement System (CalPERS) fund: applying these same return assumptions to the CalPERS portfolio for the next 15 years, a disciplined rebalancing strategy would outperform an ad-hoc one by over \$40 billion!

Disciplined rebalancing provides a clear strategy that discourages typical investors from abandoning logical, appropriate investment plans at precisely the wrong time. Disciplined rebalancing is effective, efficient and makes sense: it controls risk, helps investors stay the course, and - in the long run - enhances investment returns.