RAYMOND JAMES

# Portfolio rebalancing

A fundamental component of investment management, rebalancing keeps a portfolio on track.

When first invested, a portfolio is ideally aligned with an investment objective – the product of careful consideration of a client's goals, risk-tolerance and time horizon. Unless something changes, the portfolio likely should remain aligned with the objective. That's where rebalancing plays a key role.

## REBALANCING BASICS

Typically, more volatile, or risky, asset classes come with higher returns, which potentially lead to those asset classes growing at a faster rate than less volatile asset classes. As such, the overall risk of the portfolio can quickly become more than was initially determined as appropriate. Rebalancing is the practice of bringing the strategy back to its original allocation, and therefore the proper risk profile.

Various rebalancing approaches can be used, ranging from making no changes to setting very specific volatility-based tolerance bands around the asset classes in the portfolio. Selecting a rebalancing approach calls for careful deliberation regarding the impact it will have on maintaining the portfolio's intended risk and return characteristics.

## REBALANCING APPROACHES



Buy and hold: Buy and hold is the simplest approach. Once the assets are invested, no changes are made and the assets are free to move with the markets. The assets with the highest returns, and very likely the highest risk over time, will grow the most, which can increase the risk of the overall portfolio.



Time-based or constant mix: With this approach, asset class proportions are brought back in line at regular intervals, such as monthly, quarterly or – mostly commonly – annually. More frequent rebalancing can entail more transaction costs, short-term capital gains, and a potential loss of returns if an asset class is not given sufficient time to meaningfully appreciate.



Drift-based or contingent: This approach sets a threshold, also known as a tolerance band, around each of the asset allocations and rebalances the portfolio whenever a threshold is breached. Bands can be relative or absolute. For

### UNWANTED EMOTION

Following an established rebalancing process can help avoid these natural emotional reactions, which can drastically hinder the success of an asset allocation and significantly alter its risk/return profile[1]:

Herd mentality – In the case of investing, the tendency to do what everyone else is doing means selling assets that are underperforming and buying those that are outperforming. This is counterproductive to overall positive performance.

Regret aversion – Some investors do not want to admit they've purchased an underperforming asset, which leads to holding positions while they continue to lose.

Mental accounting – Some investors tend to compartmentalize each piece of the portfolio, and fail to understand the benefit of risk reduction through correlation, as well as the importance of how long-term performance contributes to the overall portfolio.

[1] Beach, Steven L. and Clarence C. Rose. "Does Portfolio Rebalancing Help Investors Avoid Common Mistakes?" Journal of Financial Planning, May 2005.

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example, a 10% relative band around a 40% allocation would trigger a rebalance at 44% or 36%, while an absolute band would allow the allocation to drift up to 50% or down to 30% before rebalancing.

## CONSIDERATIONS FOR DRIFT RULES

In addition to costs associated with monitoring and trading, several factors require consideration when evaluating rebalancing approaches.

Asset class volatility: More volatile, or riskier, asset classes will breach tolerance bands in either direction much more often than less volatile asset classes. So, it may be more efficient to set a wider band around more volatile asset classes, unless it is determined that frequent rebalancing is acceptable.

Asset class weighting: With absolute bands, asset classes with small allocations must increase significantly to trigger a rebalancing event. Relative bands self-adjust based on the weighting of the asset, which many consider an efficiency advantage.

Other considerations: Tax implications, market conditions, and the objective of the portfolio are some additional factors to consider when rebalancing.

## A CASE STUDY

An Advisory Consulting study of rebalancing approaches used three allocations to equity and fixed income asset classes – 50/50, 60/40 and 70/30 – over a 30-year period from January 1, 1986, through December 31, 2015.[2]

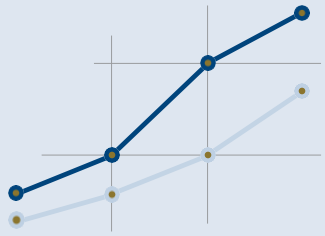
Additionally, within this 30-year period, 10- and 20-year timeframes were examined to determine whether different market environments affected the results of the rebalancing approaches, yielding nine portfolio scenarios.

Ten rebalancing approaches were studied – four time-based and six drift-based. Each rebalancing approach was applied to the nine different portfolio scenarios.

Across all rebalancing methods, allocations and timeframes, annual rebalancing most consistently maintained the portfolio's risk/return profile by providing the lowest standard deviation six of nine times and the highest return seven of nine times.

Time-based methods showed more favorable results than drift-based, but within drift-based approaches absolute bands resulted in more scenarios with higher returns and/or less risk than relative bands.

Finally, full rebalancing back to the original allocation controlled risk more consistently than rebalancing partially, or halfway, back to the original allocation.



## CONCLUSION

Maintaining a portfolio's appropriate risk profile is the objective of rebalancing. There are several rebalancing approaches and many factors to consider in selecting the one most appropriate. The goal is to determine which rebalancing method controls risk on a consistent basis and can be implemented in an efficient and timely manner.

[2] Study conducted by Amanda Morland, CPM®, Investment Research Consultant, Advisory Consulting, Raymond James.

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