Investment Planning Answer Book by Jay L. Shein, Portfolio Monitoring, Rebalancing, and Changing

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Once investment portfolios are implemented, it is important for investment advisors and consultants to monitor the portfolio and make changes as necessary, as dictated by investment policy, or based on financial, economic, or technical forecasts. Portfolios may be rebalanced, reallocated, or significantly changed.

Investment Planning Answer Book by Jay L. Shein, Q 19:1, Why is rebalancing a portfolio important?

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A rebalancing discipline may be important depending on what philosophy or strategy is used to manage a portfolio. For those advisors who choose a strategic asset allocation strategy as discussed in the chapter entitled "Asset Allocation Methodology," they may find that periodic rebalancing is a good way for them to control risk and potentially improve performance. The proportion of assets divided among different asset classes such as stocks, bonds, real estate, and cash have a significant impact on portfolio risk and performance. Even if the investment objectives of an investor stay the same, capital market conditions do change, and over time, various asset classes increase or decrease in value. No single investment style will consistently outperform another. These unplanned shifts can lead to too much exposure or too little exposure in an asset class which can increase risk and potentially reduce returns.

For example, let's consider a portfolio that contains various asset classes, among them are large growth stocks and large value stocks. The value stocks typically are companies that are out of favor by traditional valuation measures, and growth stocks are those that have growing earnings or have revenue that is going faster than their industry or overall market. Assume the investor's objectives or the investment policy indicated a mix of large capitalization stocks to be equally weighted between growth and value. By rebalancing periodically, the asset class exposure can be maintained and help keep the level of risk consistent with the investor's risk tolerance. By buying and holding which would mean doing nothing over a long period of time, the portfolio may take on more risk that the investor would want.

Investment Planning Answer Book by Jay L. Shein, Q 19:2, What is a major benefit of strategic rebalancing?

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A major benefit of rebalancing is that it keeps a portfolio from becoming too over-weighted with stocks or other asset classes. If one asset class is rising in price or inversely sinking in value, rebalancing back to the target mix can maintain the expected risk and return parameters. Rebalancing strategically is a disciplined method that sells the over-weighted asset class and buys the under-weighted one. This is effectively selling high and buying low.

Investment Planning Answer Book by Jay L. Shein, Q 19:3, What are some different methods used to rebalance a strategically allocated portfolio?

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One method is to sell the asset class that is over represented in the portfolio and to purchase the asset class that is under represented. For instance, if the initial allocation was 50 percent stocks and 50 percent bonds and has changed because stocks have fallen in value and bonds have risen in value to a portfolio with 40 percent stocks and 60 percent bonds, the advisor would sell the appropriate amount of bonds and purchase stocks to bring the portfolio allocation back to 50 percent stocks and 50 percent bonds.

Another method would be to use new funds coming into the portfolio and to invest them into the underrepresented asset class. This method will only work if new funds are being added to the portfolio. For instance, assume that a portfolio of $1 million which is initially allocated 50 percent stocks and 50 percent bonds has changed because stocks have risen in value and bonds have fallen in value where the new allocation is now 60 percent stocks and 40 percent bonds. The investor adds additional funds which the advisor would then use to buy more bonds to bring the allocation closer to the original 50 percent stocks and 50 percent bond mix. Depending on how much money is added to the portfolio, the advisor may have to also sell stocks or possibly buy bonds and stocks to bring the portfolio back to the target weighting of 50 percent stocks and 50 percent bonds. An advantage of using new money added to the portfolio is that the advisor may avoid potential tax liabilities from the sale of portfolio assets used to rebalance the portfolio.

A third method is to use income or dividends from bonds or stocks to buy more of the under represented asset class in the portfolio. Many advisors consider periodic rebalancing a fundamental principle of portfolio management.

Investment Planning Answer Book by Jay L. Shein, Q 19:4, Is passive rebalancing the same as a buy and hold strategy?

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Rebalancing a portfolio that is strategically allocated is not the same as a pure buy and hold strategy. With a buy and hold strategy, portfolios are never rebalanced. Portfolios that are never rebalanced will usually produce undesirable volatility over time. With a pure buy and hold strategy, the portfolio will tend to be on the wrong side of the investment allocation when the markets turn. When a bull market in stocks is ending without rebalancing, the portfolio is over allocated to the riskier asset class (in this example, stocks) just as a bear market is beginning. The reverse is also true. At the end of a bear market, stocks would be under allocated when the new bull market is beginning if the portfolio is not rebalanced. The approaches discussed in this question are a passive type of rebalancing strategy. Although a rebalancing decision is being made, there is an element of timing or tactical reallocation. This passive method of rebalancing does have its advantages as it is easy for advisors and investors to implement and understand. It does provide a more constant level of portfolio risk and diversification. This passive approach is a disciplined method to keep a portfolio from becoming too over weighted at the top of a market or under weighted at the bottom.

Investment Planning Answer Book by Jay L. Shein, Q 19:5, How often should rebalancing be performed?

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Many financial advisors rebalance portfolios quarterly or annually. There seems to be no scientific reason for using these time periods. Perhaps, it is because advisors may meet with their clients quarterly or have annual reviews. A lot of the literature discussing rebalancing has indicated that there is not much difference in the results for annual or quarterly rebalancing. There is a slight benefit over quarterly or annual rebalancing if a portfolio is rebalanced monthly. The biggest benefit comes when portfolios are reviewed more frequently such as every two weeks. Looking at a portfolio frequently does not mean that the portfolio is being rebalanced. It simply means that the advisor is looking to see if the portfolio needs to be rebalanced.

Investment Planning Answer Book by Jay L. Shein, Q 19:6, What should be the threshold percentage used for rebalancing?

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Many investment policy statements will give a rebalancing threshold of the normal (target) portfolio plus or minus 5 or 10 percent. For example, a portfolio of 50 percent stocks and 50 percent bonds and a rebalancing threshold of 5 percent would be rebalanced if the stock allocation became 55 percent and the bond allocation was 45 percent or vice versa. While this may be acceptable to some, the question then becomes as follows: Do you look at it quarterly or more frequently to see if the allocation is out of balance in order to rebalance it?

Investment Planning Answer Book by Jay L. Shein, Q 19:7, How high should the rebalancing ranges be?

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Investment policies will typically have a high and low range relative to the normal (target) portfolio. If the percent ranges are too high, the portfolio might miss short-term ups and downs. If the range is too low, the portfolio may only take advantage of small returns while the advisor would prefer to capture the large returns. A lot of research has been done by Gobind Daryanani, Ph.D., CFP® who found that a 20 percent of the target range was ideal. For example, a portfolio that is 60 percent stocks and 40 percent bonds would be rebalanced if the stocks increased to 72 percent of the portfolio or decreased to 48 percent of the portfolio. The bonds would have a rebalancing range of 32-48 percent. This is because 20 percent of 60 percent is 12 percent for stocks, and 20 percent of 40 percent is 8 percent for bonds. This 20 percent rule would apply to sub-asset classes and multi-asset class portfolios as well. This strategy seems to be ideal when taxes, transaction costs, and timing are considered. This strategy will typically average two rebalances per year. The important thing with this strategy is to look frequently but rebalance infrequently. Look every two weeks and rebalance when necessary. If clients are extremely tax averse, the advisor could rebalance less frequently. If possible, rebalancing should be done in tax-deferred accounts such as IRAs to reduce any negative tax consequences.

Investment Planning Answer Book by Jay L. Shein, Q 19:8, What are some of the caveats to rebalancing portfolios?

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There are limitations to portfolio rebalancing. For example, depending on the time period, frequent rebalancing may decrease portfolio returns. Also depending on what time period a portfolio is invested, rebalancing may increase risk and significantly decrease portfolio returns. For example, during periods of time where the stock market is continually declining (a bear market), a rebalancing strategy will accelerate an investment portfolio's decline. During 2008, a portfolio that was rebalanced frequently would have decreased in value even more by the end of the year. Rebalancing may have some benefits for private investors who are willing to stay invested for the long-term which is a difficult task for most investors. Dynamic portfolio allocation and rebalancing or an absolute return method for portfolio management may be more palatable for many investors.

Investment Planning Answer Book by Jay L. Shein, Q 19:9, What is dynamic asset allocation?

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Dynamic asset allocation (DAA) is a method of changing the allocation of the portfolio based on market conditions. Many advisors and investors find it difficult to adhere to a strategic asset allocation policy. A good understanding of strategic fixed asset allocation is important before an advisor tackles a dynamic approach. Dynamic rebalancing may be difficult for private investors or institutions. No one approach will dominate in all market conditions. Portfolio strategies are path dependent. Dynamic asset allocation is assumed to outperform a constant mix portfolio especially during extended bull or bear markets. Most investors are more worried about downside risk then their gains. Because of this a dynamic asset allocation approach may be preferred.

One approach to DAA is when the risky part of a portfolio outperforms the safer part, the investor or advisor would assume more risk by increasing the allocation to the riskier part of the portfolio. If the risky part of the portfolio underperforms the safer part, the investor would take less risk by changing the allocation in favor of the safer assets.

Other approaches to DAA may focus on risk as opposed to performance in making the changes between risky and safer assets. Dynamic asset allocation may reduce risk without giving up performance in the long run, but may take considerable time to learn and implement. Valuation levels, the profitability of corporations, credit spreads, the direction and level of interest rates are some of the variables that may be used to make DAA decisions. DAA can smooth volatility and reduce the frequency of large tail losses (extreme event losses).

Investment Planning Answer Book by Jay L. Shein, Q 19:10, What is the optimal asset allocation and portfolio rebalancing model?

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It has been said that portfolio management is part science and part art. This might also be said of portfolio rebalancing. There is no perfect answer. Much of the research that has been done has used historical information. Even with probabilistic forecasting models, the future might not look like the model or even like historical models. Past results are no indication or guarantee of the future. The prudent advisor will study multiple methods of portfolio management and rebalancing. There is a lot of research and publications that discuss elements of portfolio monitoring, rebalancing, and changing. The more information and knowledge an advisor has, the more informed their decisions will be.