Smart ideas about wealth

Rebalancing portfolios: science and emotion

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Part 1: Why Rebalance?

Much time is spent weighing up the expected returns of different asset classes compared to their inherent risk (the extent to which the expected return may be higher of lower than expected), because getting that dynamic right is critical to achieving an investor's long-term financial goals. Most well informed people agree that asset allocation, i.e. the assets to include in an investor's portfolio and the appropriate proportions, is the most important factor which will affect eventual returns.

Devising an asset allocation strategy, however, and implementing it, is only the start. Much less emphasis is given to the importance of maintaining the overall strategy. Over time the various assets within the portfolio will perform differently, and the carefully constructed asset allocation may be thrown off course as a result. If an asset class originally represented, say, 20% of the portfolio and as a result of market movements grew to represent, say, 40% of the portfolio, then what seems like a great asset class may undermine the long term performance of the portfolio as a result of a significant amount of uncompensated risk.

Individual investors can learn from the approach of large institutions and pension funds - who have legal obligations for the prudent stewardship of billions of pounds of assets – and make sure that they rebalance their portfolio to the agreed asset allocation. In simple terms, this involves taking money from an asset class that has performed well and reinvesting it in one that has performed poorly. Although counter intuitive, as emotionally individuals want to sell poor performing assets and buy well performing ones, rebalancing effectively imposes the discipline of 'buying low and selling high'.

So if we accept that asset allocation and rebalancing thereof is a good thing, which the investor should embrace, the question then arises what should trigger a need to rebalance? How much from the original model should the portfolio's underlying assets be allowed to deviate before rebalancing occurs? Interesting research from the United States has provided answers to this conundrum.

The Benefit Of Rebalancing

Consider the performance of two portfolios from 1995 to 2003, which was a particularly volatile time in the capital markets (*display below*). Each portfolio began 1995 with £1 million invested in the same common allocation—60% equities and 40% bonds (fixed interest) - but A was left to run its course while B was rebalanced.[2] Of course, we know what happened in the late Nineties: Equities surged in value, while bonds lagged. By virtue of its increased weighting in shares, Portfolio A initially did especially well, growing to £2.81 million at its peak. Portfolio B, meanwhile, regularly sold off some of its stocks as they appreciated and bought bonds to remain close to the original target—so it didn't gain as much, reaching £2.67 million.

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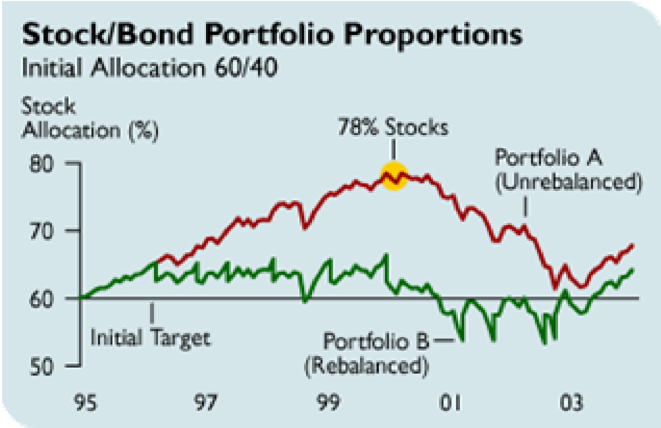
Rebalancing can be more than just protective



Growth of £1 Million			
	Peak	Subsequent Low	Ending Value
Portfolio A	£2.81 Mil.	£1.97 Mil.	£2.50 Mil.
Portfolio B	£2.67	£2.09	£2.61

Stocks are represented by the S&P 500, bonds by the Lehman Aggregate Bond Index.
Source: Compustat, Lehman Bros., and Bernstein

By 2000, A was 78% invested in equities —well above its initial target of 60%—just as the worst bear market for equities since the 1930s took hold and bond returns soared. Portfolio A lost nearly one-third of its value over the next three years, hitting a low of £1.97 million. Meanwhile, Portfolio B was better prepared for the market shift because of rebalancing: It never dipped below £2 million, and, despite not reaching the peaks that A had achieved, ended up with over £100,000 more for the entire period of good markets and bad.

The Enemy Within

Clearly, rebalancing has a logical appeal. But emotions often prove more powerful than logic, as researchers in the field of behavioral science have long known. People possess built-in biases in the way they make decisions in stressful or uncertain situations, and those biases can cause them to act counter to their own interests. For example, people have a tendency to believe that whatever is happening today will continue into the future, a bias that the research community refers to as “anchoring.” In investing, this translates into chasing what’s hot today.[3]

We can see this in a comparison of the money that US investors put into equity or bond collective funds from 1998 though 2003 (*display below*). An up bar indicates that investors favored equities and a down bar indicates that bonds were the favorite. The longer the equity bull market went on, the more money that poured into equities. In 2000, equity valuations had reached unprecedented highs, and bonds were offering unusually attractive yields. But investors kept putting more of their assets in equities, anchored in the assumption that the bull run would continue. After the stock market collapsed and bond prices took off, many investors made the opposite mistake, moving out of equities and into bonds—just in time for the markets to reverse once again.

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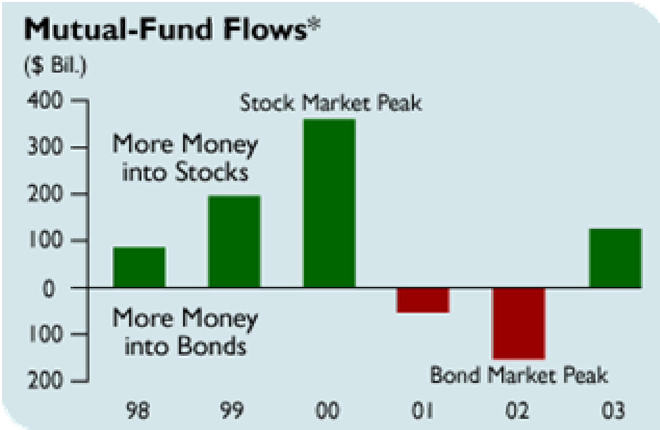
Investors' tendency to chase what's hot runs counter to the principles of rebalancing



*Excludes hybrid funds
Source: Investment Company Institute

Such biases are powerful and instinctive, working against the investor faced with a rebalancing decision. People aren't inclined to sell what's been winning and buy what's been lagging. For the health and safety of their own portfolios, they need some sort of formalised process that can take the emotion out of the rebalancing decision.

1 2002 NACUBO Endowment Study

2 In this example, the rebalancing method applied is as follows: When the equity/bond allocation shifts by at least five percentage points from its 60/40 proportions, the over weighted asset is sold and the underweighted asset is bought until the proportions are halfway back to the original target.

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