Portfolio rebalancing in the recent market environment

NOV 28, 2017 | BY FREDERIC SLADE

With current equity markets highly valued, is it time for portfolio rebalancing? (Photo: Shutterstock)

Recent stock market highs have made it tempting for investors to let their portfolio “ride” the trend of these returns without adjusting their asset mix.

How can investors keep their portfolio allocations from drifting too far from their desired target allocations and potentially increasing their exposure to sudden market downturns?

A well-known form of adjustment is known as rebalancing. Rebalancing can be defined as reducing the percentage of the portfolio in the higher performing asset class and increasing the percentage in the underperforming asset class.

Rebalancing can be done either on a calendar basis (monthly, quarterly, annually) or when a threshold is exceeded (e.g. when stocks appreciate by 10% or more versus bonds over a 4-week period).

RELATED

Asset managers' profits threatened by Rothification

Employer advocates and the financial services industry argue Rothification would harm workers' efforts to save for retirement -- but one...

Given that current equity markets are highly valued with the added specter of higher interest rates and geopolitical risks, there may be several potential benefits to rebalancing.

These include maintaining diversification over the long term; maintaining one's asset mix within reasonable ranges; and reducing the vulnerability of the portfolio to unexpected market corrections.

While the benefits of rebalancing are always sensitive to the time period involved, it is useful to illustrate a simple example of a target 60% stock (S&P 500 Index) and 40% bond (Bloomberg Barclays US Aggregate Bond Index) portfolio.

The chart below summarizes several rebalancing scenarios (click to enlarge):

	No Rebalancing		Monthly Rebalancing		Annual (End of Year) Rebalancing	
Time Period:	Annualized Return	Return /Risk	Annualized Return	Return /Risk	Annualized Return	Return /Risk
1/2008-8/2017	6.50%	0.77	6.67%	0.71	6.84%	0.75
9/2012-8/2017 (5 years)	9.47%	1.58	9.46%	1.63	9.58%	1.65
1/2008-12/2009 (2 years)	-3.88%	-0.30	-3.94%	-0.26	-3.05%	-0.21
Target Stock/Bond Mix	60%/40%		60%/40%		60%/40%	
Ending Stock/Bond Mix	67.8%/32.2%		59.9%/40.1%		62.3%/47.7%	

Risk is defined as the annualized standard deviation of returns.

Overall, the greatest benefit (higher annualized return and higher return/risk) resulted from annual rebalancing as opposed to no rebalancing or monthly rebalancing. This included the 2008-09 period when there was significant market volatility due to the 2008 financial crisis.

Comparatively, monthly rebalancing resulted in the least amount of asset mix drift (actual versus target allocation); however, an additional consideration with monthly rebalancing is that it may result in significant trading costs and tax impacts.

The greatest asset mix drift resulted when there was no rebalancing. Annual rebalancing resulted in some drift, but much less drift than with no rebalancing.

In summary, it makes sense to look at one's portfolio allocation versus one's target allocation on a periodic basis.

In the above illustration, a once per calendar year rebalancing had the potential to add value on a risk-adjusted basis, and importantly, to guard against drift in the portfolio's asset mix due to gains which may reverse in the future.

NOTE: Information presented herein is for discussion and illustrative purposes only and is not a recommendation or an offer or solicitation to buy or sell any securities. Past performance is not a guarantee of future results.

Frederic P. Slade, CFA is the Assistant Vice President and Senior Director, Investments at Pentegra Retirement Services.