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New Year: Should You Rebalance Your Portfolio?

The question of when, why and how you should rebalance your portfolio gets attention from the media on a cyclical basis, and despite all of the column-inches devoted to the subject and nudges from fund companies, the conclusions are often the same--sell your winners and buy your losers at least once a year if not once a quarter. This discussion may seem particularly relevant now after all of the volatility we've seen in the markets over the last few years, which has pushed many portfolios far from their original allocations.

However, when we look at the data, we have to wonder if rebalancing is necessary that often, if at all, even during times of increased market volatility.

Proponents of rebalancing will tell you that the strategy is all about risk control--by sticking to a target allocation between stocks and bonds, growth and value, domestic and international, small-cap and large-cap, and so forth, you can effectively manage the overall risk of your portfolio through various market cycles. To use the standard example, if you had a 60%-40% mix of equity and bond funds in a portfolio, after a period of stock outperformance your portfolio could become skewed to a 65%-35% or 70%-30% mix, putting you at increased risk if stocks begin to decline. The theory behind rebalancing is to keep those allocations in check, thus reducing risk. And on the face of it, it's good advice--but only superficially.

Vanguard and Fidelity have addressed the subject of rebalancing a number of times over the last few years, with the firms recommending rebalancing on a semiannual or annual basis, or when allocations drift more than 5% or 10% away from their targets.

Those conclusions seemed a bit simplistic to us, but before making any judgments we wanted to look at a few numbers for ourselves. We constructed a hypothetical portfolio of Vanguard funds with a 60%-35%-5% split between equities, bonds and cash (50% to 500 Index, 10% to Total International Index, 35% to Total Bond Market Index and 5% to Prime Money Market) and tracked the results of several rebalancing scenarios from January 1987 (a few months after 500 Index's inception) through December 2010. (Note: For the period prior to Total International Index's April 1986 inception we used returns data for the MSCI EAFE Index.)

In the first scenario we rebalanced the portfolio every six months--in January and July. In our second test we rebalanced once a year in January, in the third we rebalanced every third January, and of course we compared these results

to a scenario involving no rebalancing at all. (We picked January to rebalance because it's best to do it after December distributions and after the tax-year has turned.)

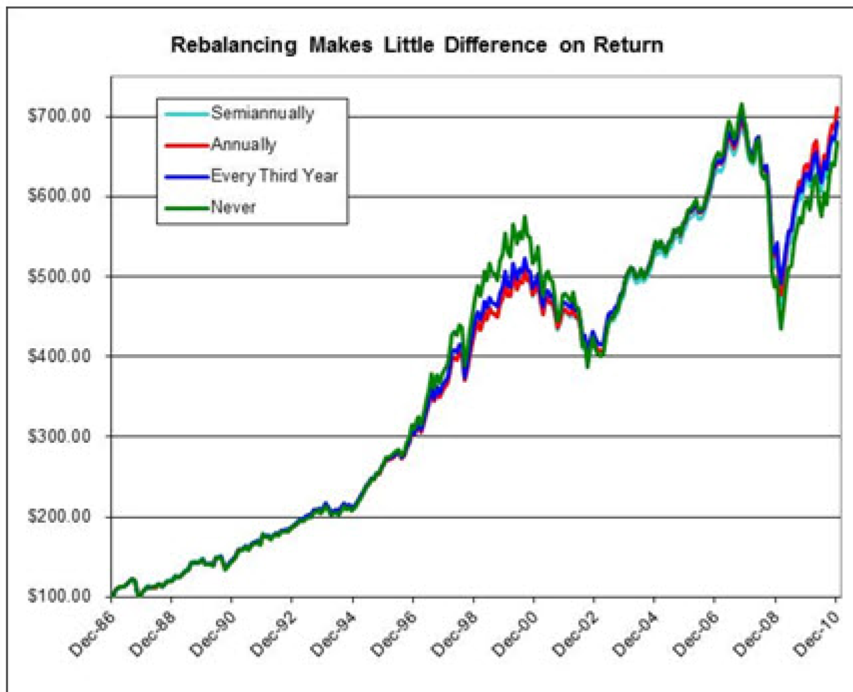
Rebalancing Has Little Effect on Average Returns

Frequency				
Semiannually	**1-month**	**1-year**	**3-year**	**5-year**
Best	8.18%	34.11%	20.55%	18.28%
Average	0.71%	8.43%	8.12%	8.44%
Worst	-11.51%	-27.63%	-7.03%	-1.61%
Annually				
Best	8.18%	34.25%	20.74%	18.47%
Average	0.72%	8.55%	8.27%	8.59%
Worst	-12.83%	-26.68%	-6.71%	-1.35%
Every 3 Years				
Best	8.18%	32.44%	21.37%	18.98%
Average	0.71%	8.46%	8.26%	8.59%
Worst	-12.83%	-24.76%	-6.91%	-0.77%
Never				
Best	8.18%	37.11%	23.94%	21.51%
Average	0.71%	8.49%	8.09%	8.50%
Worst	-13.17%	-32.61%	-10.78%	-3.21%

Source: Adviser Investments

The table above is a summary of the rolling returns for each scenario, showing average returns as well as best and worst returns for one-month, one-year, three-year and five-year periods. The table is pretty conclusive: the fewer times you rebalance, the greater the return potential and greater the volatility. When we've run these scenarios in years past, the portfolio that was never rebalanced came out as the clear winner over all periods in terms of average performance. After the volatility we experienced in 2008 and 2009 (and despite the subsequent return towards normalcy in 2010), however, the portfolio rebalanced every year moved up to top the leader board. It's worth noting that no matter which period you look at, the average returns in each scenario are all very similar, with no more than 18 basis points separating any two of them. But you can see much wider swings when comparing the best and worst periods.

So from a volatility standpoint, rebalancing does appear to have a positive effect on a portfolio--you won't hit the same heights, but neither will you experience the same losses an untended portfolio experiences. A portfolio that is frequently rebalanced also stays much closer to its targeted allocation, but can still be affected by periods of high market volatility, as was the case in 2008 and 2009 and even the last few months of 2010, a year in which overall stock market volatility declined from previous years. Through year-end 2010, the portfolio that was never rebalanced ended up with a roughly 72%-26%-2% split between stocks, bonds and cash, while the most frequently rebalanced portfolio--even having been rebalanced just 5 months ago--was pushed significantly off of its original 60%-35%-5% allocation, ending up with a roughly 65%-31%-4% stock/bond/cash split.



Source: Adviser Investments

As you can see in the chart above, over the long haul, returns really don't suffer that much for the more frequently rebalanced portfolios even though they showed lower average returns over shorter periods. In fact the difference in the end value of the never rebalanced and the semiannually rebalanced portfolios was just over 4% after over two decades! That's hardly an argument for never rebalancing, but it's not much of one for doing it often, either. Or as former Vanguard Chairman Jack Bogle put it a few years back, "rebalancing is a personal choice, not a choice that statistics can validate."

Next Time

This week, we ran the numbers and found neither a convincing argument for or against frequent rebalancing--even in volatile markets--but there's more to the issue than just performance. In our next *Adviser Fund Update*, we'll have more on the subject, including key concerns that anyone developing a rebalancing strategy needs to consider, so check back in two weeks.

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