ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

January 8, 2009

Is it Time to Rebalance?

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, as the markets have gone through violent upheaval over the past year, pushing most 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 bond outperformance your portfolio could become skewed to a 55%-45% or 50%-50% mix, putting you at increased risk if bonds 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 has addressed the subject of rebalancing a number of times over the last few years, most recently with an article posted on its website in April 2008. Prior to that, they covered the subject in greater detail in a February 2006 research paper titled "Portfolio Rebalancing in Theory and Practice," as well as in a podcast posted on their website in September 2006 (there were also a couple of shorter articles on the subject posted up in 2007, and they're probably due for another go-round of the subject again soon). All reports conclude that rebalancing reduces risk. The podcast went further, suggesting, anecdotally, that rebalancing also has the potential to improve returns if conducted in a disciplined and regimented manner, which Vanguard continues to define as semiannually, annually, or when a position moves 5% or more out of its targeted allocation.

However, Vanguard's February 2006 report, which used over 40 years of market data to test out various rebalancing strategies, showed

In This Issue

some surprising results—that the less frequently you rebalance, the higher your overall return will be. Despite these results, the report concludes by suggesting that "annual or semiannual monitoring, with rebalancing at 5% thresholds, produces an acceptable balance between risk control and cost minimization." Fidelity also has a few articles addressing rebalancing up on its website, and although none of them go into quite as much depth as the Vanguard reports, they also suggest reviewing and, if necessary, adjusting a portfolio on a semiannual or annual basis or when allocations drift more than 10% away from the target.

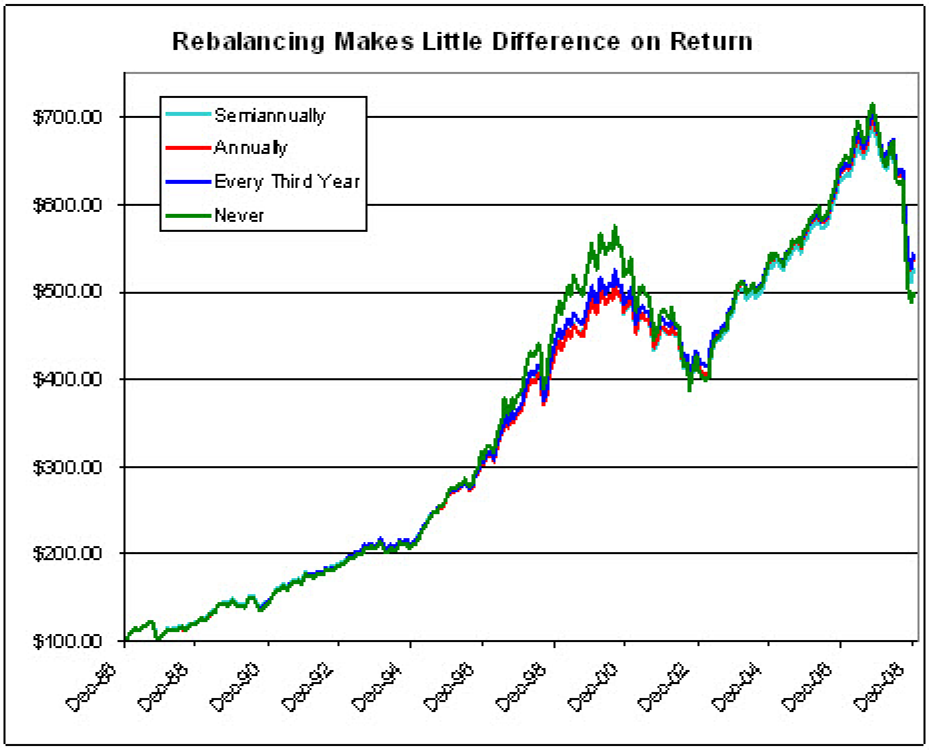
Those conclusions seemed a bit simplistic to us and not quite so foregone, especially based on Vanguard's own findings. But before making any judgments we wanted to look at a few numbers for ourselves. Curious to see if we would come up with similar findings to Vanguard's, we constructed a hypothetical 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 2008. (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.) Even though we've known the results of Vanguard's study for a couple of years now, we were mildly surprised this year to see that the portfolio that is never rebalanced (and thus has become "riskier" as it has a more aggressive stock allocation) maintained the highest average return of the four over a majority of periods, albeit by a rather slim margin.

Average Returns Increase the Less Often You Rebalance

Frequency				
Semiannually	**1-month**	**1-year**	**3-year**	**5-year**
Best	8.18%	30.81%	20.55%	18.28%
Average	0.67%	8.78%	9.13%	9.11%
Worst	-11.51%	-24.28%	-7.03%	0.29%
Annually				
Best	8.18%	31.38%	20.74%	18.47%
Average	0.68%	8.87%	9.25%	9.25%
Worst	-12.83%	-23.40%	-6.71%	0.56%
Every 3 Years				
Best	8.18%	32.44%	21.37%	18.98%
Average	0.68%	8.91%	9.29%	9.28%
Worst	-12.83%	-23.64%	-6.91%	0.56%
Never				
Best	8.18%	37.11%	23.94%	21.51%
Average	0.66%	8.97%	9.36%	9.33%
Worst	-13.17%	-29.88%	-10.78%	-1.21%

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 and greater the volatility. 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 23 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. Through December 2008, the portfolio that was never rebalanced ended up with a roughly 67%-31%-3% 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 50%-44%-6% stock/bond/cash split. Of course 2008 was an historic year for volatility, and 5-month swings of the magnitude we just experienced do not occur frequently.

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 5% 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 ago, "rebalancing is a personal choice, not a choice that statistics can validate." Bogle recently confirmed that he still walks his talk, telling a radio interviewer that he hasn't changed his own asset allocation since March of 2000.

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.

Fidelity Manager Moves

With the end of the old year and the start of the new, Fidelity made a few manager changes, none of which should be cause for concern for investors in the affected funds.

As of the first of the new year, Andrew J. Dierdorf and William Hall began serving as co–portfolio managers of Fidelity Four-In-One Index, succeeding Derek L. Young and Christopher L. Sharpe. Young will continue to manage the Asset Manager Funds and Global Balanced and will remain co-manager on Strategic Dividend and Income, Strategic Income, Advisor Strategic Income and Strategic Real Return. Sharpe will continue to co-manage the Freedom funds, the Income Replacement funds and Fidelity's 529 College Savings Plans with Dierdorf. Dierdorf will continue to co–manage Dynamic Strategies and manage lifecycle funds designed for Canadian investors. Before joining Fidelity in 2004, Dierdorf worked for CIGNA, where he held various actuarial and investment positions. Hall joined Fidelity in 2002 as a senior portfolio analyst supporting the bond and money market funds. Since 2005, he has been an analyst in the Global Asset Allocation group. Prior to joining Fidelity, Hall worked as a municipal bond trader and analyst for Gannett Welsh & Kotler, a Boston-based money management firm.

Also as of January 1st, Stephen Barwikowski and Christopher Lin became co-managers responsible for Select Electronics and Advisor Electronics, replacing Paul Jackson and Christopher Lee. Barwikowski joined Fidelity in 1999 as a research analyst, initially covering the restaurant, supermarket, small-cap gaming and small-cap technology sectors in the high-yield are until 2002, when he became a part of the High-Income Division, where he followed technology and telecomm companies. Lin has been following the semiconductor and video game industries as an equity research analyst since July 2008. He joined Fidelity's equity research group in 2003 and previously followed biotechnology and health-care services stocks.

As of December 31st, 2008, Nicholas Price began managing Japan Smaller Companies solo, succeeding Kenichi Mizushita. Price joined Fidelity in 1993 as an equity research analyst and over a number of years covered the brokerage, consumer electronics, major banks, pharmaceuticals and retail industries. In 1999, he began managing funds investing in Japanese equities for non-U.S. investors.

About Adviser Investments

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