ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Vanguard Launches Muni Index Fund

Early in January, Vanguard announced that it would launch Tax-Exempt Bond Index fund (and its accompanying ETF shares) in the second quarter of 2015, a renewal of its previously abandoned effort to introduce a municipal bond index fund.

The fund will be overseen by Adam Ferguson, a portfolio manager in Vanguard's fixed income group. Ferguson has been at Vanguard since 2004.

The announcement marked the second time in almost five years that Vanguard has lofted plans to issue a muni-bond index fund. In June 2010, the firm filed an SEC proposal to launch three municipal bond index funds focusing on the short-term, intermediate-term and long-term spaces. Vanguard withdrew that proposal in January 2011.

During the four years between then and now, the S&P National AMT-Free Municipal Bond index—which the new Vanguard fund will track—gained 24.8%. It was handily outperformed by Vanguard's actively managed Long-Term Tax-Exempt fund, which has a similar average effective maturity and returned 28.9% over the same period.

The tax-exempt interest from municipal bonds has been an increasingly popular option for people in high tax brackets, which may be why Vanguard has decided to have a second go at the space after scrapping its previous effort.

Tax-Exempt Bond Index will go head-to-head with the $4.2 billion iShares S&P National AMT-Free Municipal Bond ETF, which charges a 0.25% expense ratio. At its launch, Vanguard's ETF will charge 0.12%. The ETF shares will likely be the most popular option for investors, as the open-end mutual fund's Investor and Admiral shares come burdened with a 0.50% front-end load.

Does Portfolio Rebalancing Work?

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 is particularly relevant after the strong run for U.S. stocks in 2013 and 2014, which has pushed many portfolios away from their original allocations.

However, looking at the data, there is reason to question if rebalancing is necessary that often, or 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, bonds and various other asset classes, you can effectively manage the overall risk of your portfolio through various market cycles. For example, say you started with a very simple 50%–50% mix of equity and bond funds in a portfolio. After a period of stock outperformance, it could become skewed to a 60%–40% 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 rebalancing a number of times over the years, with the firms recommending rebalancing either 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 index funds with a 50–50% split between stocks (Vanguard 500 Index) and bonds (Vanguard Total Bond Market Index) and tracked the results of several rebalancing scenarios from January 1987 (just after Total Bond Market's inception) through December 2014.

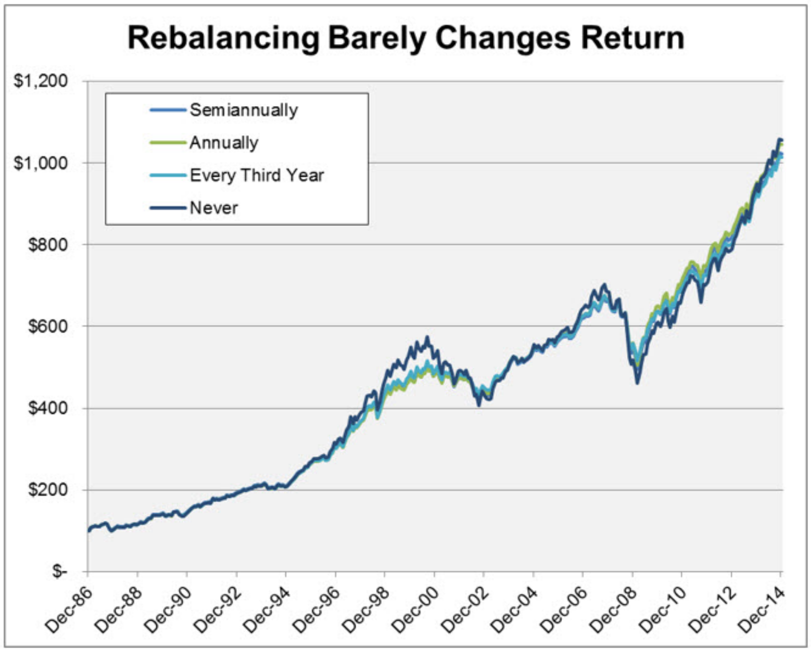
In the first scenario, we rebalanced the portfolio every six months, in January and July. In our second test, we rebalanced once a year in January, and in the third we rebalanced every third January. We also included a scenario with no rebalancing. (We picked January to rebalance because it's best to do it after December distributions and after the tax-year has turned.)

When we looked at rolling returns for each scenario, examining average returns as well as the best and worst returns for one-month, one-year, three-year and five-year periods, our findings were pretty conclusive: The less frequently you rebalance, the greater the return potential and greater the volatility over any given period. However, when you average things out, a couple of the rebalancing schemes did result in slightly better returns over shorter periods.

It's worth noting that no matter which period we looked at, the average returns in each scenario are all very similar, with no more than 37 basis points separating any two of them. But you can see much wider swings when comparing the best and worst periods, for example, there was a 65% swing from best to worst 12-month periods for the portfolio that was never rebalanced compared to a 51% or 52% swing for the three regularly rebalanced portfolios.

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 can suffer. 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.

Through year-end 2014, the portfolio that was never rebalanced ended up with a roughly 73%–27% split between stocks and bonds, while the most frequently rebalanced portfolio—most recently in July 2014—ended up 51%–49%.



Sources: Morningstar, Adviser Investments.

As you can see in the chart above (which tracks the growth of $100 in hypothetical portfolios split between stocks and bonds using the various rebalancing schemes), 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 $34. That's hardly an argument for never rebalancing, but it's not much of one for doing it often, either.

But what if you followed the recommendations of Fidelity and Vanguard, and instead of using time periods to determine your rebalancing strategy, you used portfolio drift? In the table below, we tested what would have happened to that 50%–50% portfolio over the same 28-year period, this time rebalancing when the spread between stocks and bonds exceeded 5% or 10%.

Using Portfolio Drift Has Little Impact on Performance

	# of Trades	Avg. Months Between Trades	Fewest Months Between Trades	Most Months Between Trades	Total Return	Annualized Return
No Rebalancing	0	—	—	—	956%	8.78%
10% Spread	17	20	3	75	953%	8.77%
5% Spread	44	8	1	49	934%	8.70%

Sources: Morningstar, Adviser Investments.

If you just look at the number of trades and the average months between, it seems like a pretty doable strategy—with a 5% spread threshold, you would have made a trade about once every eight months, and you would have traded once every year and a half or so with a 10% threshold. But that's misleading—the frequency of trades varied significantly over the 28 years, with a few periods requiring a flurry of activity after longer gaps with no trades. For example, with a 5% threshold, from January 2008 to January 2010 you would have made seven trades as stock market declines regularly pushed the balance of the portfolio towards bonds—meaning that you would have been repeatedly faced with the difficult psychological task of putting more money into stocks as their value was falling.

But even if you were that disciplined, and you had made those painful trades—what would it have gotten you? From a return standpoint, not very much. As with the time-based rebalancing schemes, there was very little difference in overall return between the portfolio that was never rebalanced and the ones that were. Former Vanguard Chairman Jack Bogle summed it up pretty well a few years back: "Rebalancing is a personal choice, not a choice that statistics can validate."

Coming Up
This week, we looked strictly at returns and found neither a convincing argument for nor against frequent rebalancing, but there's more to the issue than just performance. In an upcoming *Adviser Fund Update*, we'll have more on the subject, including key concerns that anyone developing a rebalancing strategy needs to consider, so please check back in the weeks ahead.

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