ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

January 17, 2014

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How Often 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 the strong run for U.S. stocks in 2013, which has pushed many portfolios away from their original allocations.

However, when we look at the data, there is reason to question 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, 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 the subject of 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 2013.

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.)

Rebalancing Has Slight Effect on Average Returns

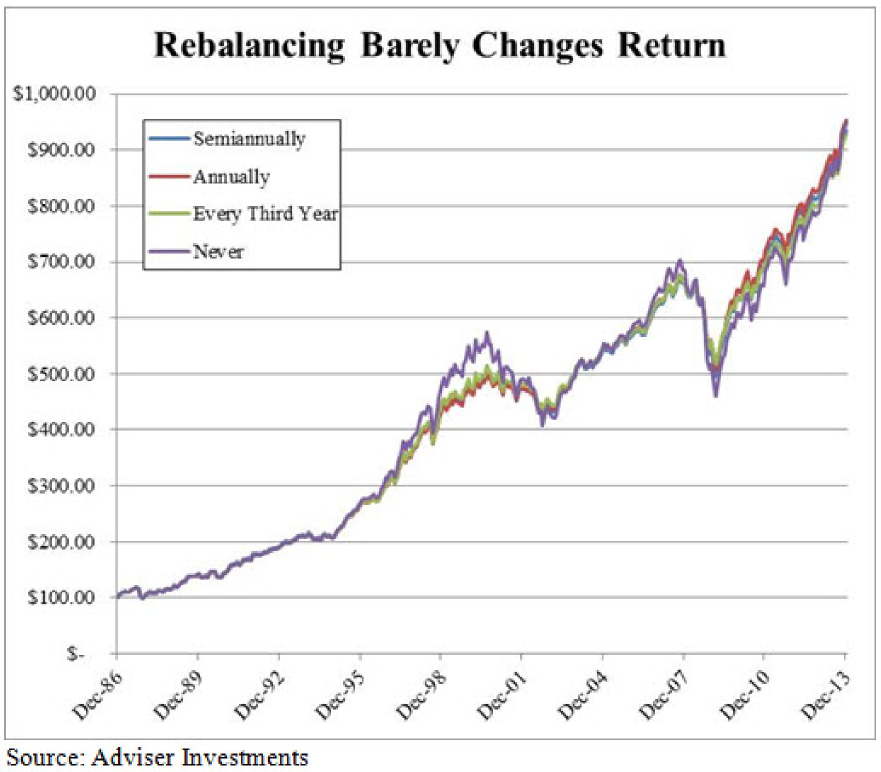
Frequency	1-month	1-year	3-year	5-year
Semiannually				
Best	7.3%	30.2%	20.6%	17.9%
Average	0.7%	8.7%	8.5%	8.2%
Worst	-9.7%	-22.2%	-4.8%	-1.0%
Annually				
Best	7.3%	30.9%	20.8%	18.1%
Average	0.7%	8.8%	8.6%	8.3%
Worst	-11.3%	-21.3%	-4.5%	-0.8%
Every 3 Years				
Best	7.3%	32.0%	21.6%	18.7%
Average	0.7%	8.7%	8.5%	8.2%
Worst	-11.3%	-19.4%	-3.8%	-0.3%
Never				
Best	7.7%	36.6%	24.0%	21.3%
Average	0.7%	9.0%	8.5%	8.1%
Worst	-11.8%	-28.5%	-9.0%	-2.6%

Source: Adviser Investments.

The table above is a summary of the rolling returns for each scenario, showing average returns as well as the best and worst returns for one-month, one-year, three-year and five-year periods. The table is 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 the three- and five-year periods. 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 29 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 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, as was the case in 2008 and 2009.

Through year-end 2013, the portfolio that was never rebalanced ended up with a roughly 65%–35% split between stocks and bonds, while the most frequently rebalanced portfolio—most recently in July 2013—ended up 52%–48%.



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 under 2% after 27 years! 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 27-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	—	—	—	849%	8.69%
10% Spread	17	19	3	75	861%	8.74%
5% Spread	43	8	1	49	843%	8.66%

Source: 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 27 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."

Next Time

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 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 please check back in two weeks.

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