ADVISER INVESTMENTS

# ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

February 8, 2008

## Do You Need 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 the conclusions are often the same—sell your winners and buy your losers at least once a year if not once a quarter.

But when we look at the data, we have to wonder if rebalancing is necessary that often, if at all.

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 equity 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 addressed the subject of rebalancing a few times over the last few years, most recently with an article posted on its website in October 2007. 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. All three 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 defines 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 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. We believe that, for most investors, these conclusions are wrong, and too simplistic, ignoring the fact that sticking with winners, and avoiding the taxes inherent in a frequent "rebalancing" strategy, will leave you with more money, not less at the end of the day.

**In This Issue**

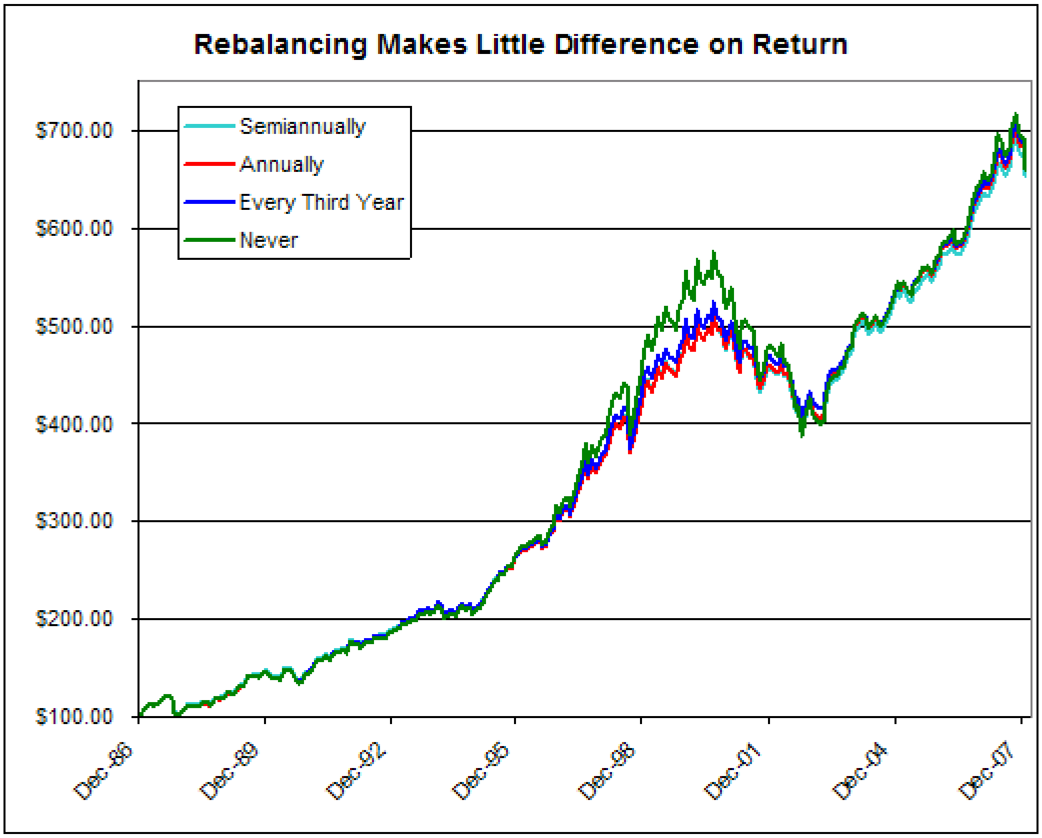
But first we wanted to look at a few numbers for ourselves. Curious to see if we would come up with similar findings to Vanguard's, we constructed a hypothetical portfolio of Vanguard funds with a 60%-35%-5% split between equities, bonds and cash (50% to 500 Index, 10% to Total International Index, 35% to Total Bond Market Index and 5% to Prime Money Market) and tracked the results of several rebalancing scenarios from January 1987 (a few month's after 500 Index's inception) through January 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 knew the results of Vanguard's study, we were still mildly surprised to see that the portfolio that was never rebalanced achieved the highest return of the four, albeit by a rather slim margin.

**Least Rebalanced Has Highest Returns**

| Frequency | | | | |
|---|---|---|---|---|
| **Semiannually** | **1-month** | **1-year** | **3-year** | **5-year** |
| Best | 7.22% | 30.81% | 20.55% | 18.28% |
| Average | 0.77% | 9.62% | 9.41% | 9.27% |
| Worst | -7.88% | -12.67% | -7.03% | 0.29% |
| **Annually** | | | | |
| Best | 7.41% | 31.38% | 20.74% | 18.47% |
| Average | 0.78% | 9.71% | 9.54% | 9.42% |
| Worst | -8.33% | -12.05% | -6.71% | 0.56% |
| **Every 3 Years** | | | | |
| Best | 7.24% | 32.44% | 21.37% | 18.98% |
| Average | 0.78% | 9.76% | 9.57% | 9.45% |
| Worst | -9.47% | -12.47% | -6.91% | 0.56% |
| **Never** | | | | |
| Best | 7.74% | 37.11% | 23.94% | 21.51% |
| Average | 0.79% | 9.99% | 9.70% | 9.53% |
| Worst | -10.84% | -19.31% | -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 37 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, as would be expected. Case in point, the portfolio that was never rebalanced ended up with a roughly 76%-22%-2% split between stocks, bonds and cash, while the most frequently rebalanced portfolio was within a few percentage points of its original 60%-35%-5% allocation (market volatility pushed allocations around a bit at the end of 2007 and in January 2008, when the most recent rebalancing took place).

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 1.2% 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, "rebalancing is a personal choice, not a choice that statistics can validate."

**What’s the Cost?**

There is one very strong argument against becoming a rebalancing fanatic, and that's cost. When conducting our analysis we assumed that all distributions were reinvested along the way, and did not factor in transaction fees or taxes on realized gains from trades. But these are both very important issues to consider when thinking about a rebalancing strategy.

If you choose to rebalance annually or even more frequently in a taxable portfolio, carefully review how the various transactions you'll need to make will affect your tax return as well as any fees you might incur—do funds in your portfolio have front- or back-end loads or short-term trading fees? Are you buying into a fund paying a distribution? (While Total International pays distributions annually, 500 Index pays out quarterly.) Will the sale of a fund create a taxable gain? These are all questions you should be asking yourself when developing a rebalancing strategy. (Even though taxes won't be an issue if you're rebalancing your IRA, 401(k) or any other tax-free account, you still should consider fees and expenses from trades.)

However, there are more ways to rebalance than just buying and selling out of the funds in your portfolio on a fixed schedule. One of the simplest, and one we've recommended for years is to re-direct distributions to or make new investments in the under-allocated funds in a portfolio. Or if you're at the point where you're drawing on the portfolio for income, take withdrawals out of your winners to reduce their allocation (this of course will generate its own tax bill, but of course you can't avoid taxes forever if you're drawing down your account). These kinds of moves will be the most effective in keeping taxes and expenses down when compared to making numerous trades over the course of a year.

**Be Clinical or Don't Bother**

There's another issue at stake in rebalancing that often gets short shrift, and that's the human factor. It's easy enough to calmly discuss rebalancing a hypothetical portfolio, but when it comes to reality, many investors may find the idea counterintuitive, as it requires you to reward the losers in your portfolio with more money while reducing your exposure to the proven winners.

If you have a fund in your portfolio that's been burning up the markets month after month, you're probably not going to want to sell it to invest more in a fund that's been losing you money. But the standard theory of rebalancing requires that you do exactly that, and not just once, but over and over and over. As Jack Brennan, Vanguard's Chairman has said, "If you are going to rebalance, you have to be absolutely clinical, or you are better off not doing it." We share this view.

Of course you could take the more laidback route and rarely rebalance—if at all—so long as you have a tolerance for the increased volatility that is part of an "unbalanced" portfolio. And when you figure the tax bill on frequent trades, you could come out substantially ahead. As illustrated by our analysis, from a returns standpoint, going with the flow isn't that bad an idea.

Several more things to consider: If you do choose to rebalance on a set schedule, is your target allocation still appropriate—do you still have the same investment goals as when you started? Over a 21-year period such as the one we looked at, or even the 40-year period Vanguard looked at, your allocation might need a change, requiring even more buying and selling. Do you have a lower or higher tolerance for risk? Just because you picked a certain allocation at one point doesn't mean that it suits your purposes now. Are you prepared for the headaches and tax implications of making multiple trades per year? While many firms allow you to make trades online, you still open yourself up to having to review more paperwork, track all of the changes to make sure there weren't any errors (on your part or the fund company's) and fill out extra lines on your tax return for every capital gain realized. This seems like a lot of extra hassle to us for a reduction in risk and in total return.

So is rebalancing necessary? Even though the media or your fund company may have you think so, when you look at the evidence, there is little benefit when it comes to the portfolio's returns, and only some benefit when you think about risk. (And this assumes no tax consequences.) Our recommendation would be to make a few trades over the course of several years, as we do for our clients, as opposed to being overly active each year with potentially costly trades that are not going to improve your returns. Of course, if rebalancing frequently gives you peace of mind *and* you're willing to be clinical about it, your portfolio will not suffer too much for it either.

## About Adviser Investments

Adviser Investments is an independent, professional money management firm specializing in Fidelity and Vanguard mutual funds. With 1,400 clients and $1.2 billion dollars under management, Adviser is one of the nation's largest mutual fund research and money management firms. Our staff of 35 investment professionals focuses on helping individual investors, trusts, foundations, and institutions meet their investment goals. Our minimum account size is $350,000.

For more information, please visit www.adviserinvestments.com or call 800-492-6868.



Adviser Investments
85 Wells Avenue
Newton, MA 02459
USA