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Rebalancing an Investment Portfolio

A guide to rebalancing and what this means

Introduction

Rebalancing is an investment concept which provides a cornerstone to the successful application of an asset allocation approach to investing.

To rebalance a portfolio is to bring it back into line with its stated objectives on a regular basis, to keep the portfolio aligned to its core position and by default, to stop it getting out of line.

In this respect it acts as a management construct, to enable an investor and their adviser to manage the portfolio in a disciplined way. There is the added advantage that this helps with risk management.

Rebalancing is a concept which extends to a number of investment structures.

For example it can be, and often is, used within a share portfolio to keep the portfolio balanced as to its various holding of shares. The concept is rigid in that it is based on the logic of maintaining the right balance between different holdings in any type of portfolio. However, we are only considering rebalancing – in this guide – from the viewpoint of an asset allocation portfolio, all of which will we explain below.

A simple start point

To provide a straightforward example of how and why rebalancing works, it is easiest to begin with a very simplistic portfolio.

Take an investor who has £100,000 to invest who decides, based on their financial (and risk) position, aims and ambitions that they wish to allocate their money into just two asset classes: Government Bonds (Gilts) and Shares (Equities) and they wish to place the money 50/50 between the two.

Consequently, they allocate £50,000 into Equities and £50,000 into Gilts.

Over the course of the following year, the Equity portion rises in value by 20% and the Gilt portion falls in value by 10%.

At the end of this first year they now have:

Equities	£60,000
Gilts	£45,000
Total	**£105,000**

The portfolio overall has risen by 5%.

The asset allocation has also changed so that the investor now has 60/105 or 57% in Equities, 45/105 or 43% in Gilts (we round the percentages to the nearest whole number for ease of use).However a year earlier the optimum asset allocation was 50/50. The investor is out of line from their original position.

They do nothing – the next year the Equities rise by 20% and the Gilts fall by 20%, now the position at end of year two is:

Equities	£72,000
Gilts	£36,000
Total	**£108,000**

The portfolio overall is still going up (a benefit of diversification) but the asset allocation is now way out of kilter from the original objective.

The assets are now split:

Equities	72/108 or 67%
Gilts	36/108 or 33%

The investor who was balanced is now very imbalanced!

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To follow this through, imagine if no action is taken and in year three Equities fall by 30% and Gilts rise by 10%.

The portfolio now looks like this:

Equities	£50,400
Gilts	£39,600
Total	**£90,000**

Now the portfolio is down because of the Equity fall.

This pathway has involved no rebalancing.

How rebalancing works

To see how rebalancing works, we will examine the position which would have arisen in this same example if the investor had rebalanced once per year on the anniversary, rebalancing back to their original 50/50 split.

At the end of year one, the position was:

Equities	£60,000
Gilts	£45,000
Total	**£105,000**

A rebalance would change the holdings so that each asset area represented a 50% holding. £7,500 worth of Equities would be sold and £7,500 worth of Gilts bought, meaning that at the start of year two the portfolio would be £52,500 in each area.

The second year saw an Equity rise of 20% and a Gilt fall of 20%: this means the rebalancing investor would have values of:

Equities	£63,000
Gilts	£42,000
Total	**£105,000**

Again, the portfolio would be rebalanced at the end of year two – back to £52,500 in each (£10,500 of Equities sold and £10,500 of Gilts bought).

It is year three where we see this working for the good for the first time:

Equities fall by 30% and Gilts rise by 10% leading to an end of year three position as follows:

Equities	£36,750
Gilts	£57,750
Total	**£94,000**

The portfolio is still down but not as much – a 6% fall not a 10% fall. Of course at this point the rebalancing investor would adjust again to 50/50, putting £47,000 in Equities and £47,000 in Gilts. They have £10,000 more in Equities at the start of year four than the investor who does not rebalance.

Of course, the example above is not particularly realistic because few investors will apply an asset allocation approach which uses just two asset classes. Most investors will diversify across a much broader range of asset types.

Assets such as Cash, Overseas Equities, Overseas Government Bonds, UK and Overseas Corporate Bonds, Commodities and Property could all be within a typical portfolio, as well as UK Equities and UK Gilts. This means a portfolio could easily hold 8-10 different asset types.

Clearly this makes the rebalancing exercise more complicated, because there is now a need to keep 8-10 different asset percentages in line.

However this does not affect the overall theory or value of the exercise and with modern day 'investment platforms' it is easy to keep a daily check on a portfolio and to see a breakdown of the asset percentages as the underlying values rise and fall.

The asset allocation approach

Rebalancing effectively acts as part of a longer term approach to investing which is built upon the foundation of an asset allocation approach. It is worth taking some space to explain more about this approach, why we favour it and how this works.

Approaching the investment requirement of an investor, we aim to make sure that we get the investment portfolio in a place which meets the investor's objectives.

An investor's risk tolerance is measured by assessing how much of their invested money can be risked and to what extent in the future and this is tested against the impact this would have on the investor's position if the investments perform poorly and losses are incurred. We therefore undertake a risk assessment with an investor to try, as far as is possible, to gauge their risk position.

Once assessed and a measurement applied to this risk position we then look to make sure, again as far as one possibly can, that a suitable portfolio is constructed to meet this risk position.

Part of reducing risk is to ensure that there is a good diversification of asset classes used. This is because assets rise and fall in value at different rates, at different times. This means that while some are going up, some might be going down and then through a later period, the opposite may occur. Diversification of the assets aims to provide a mix which reduces the impact of these fluctuations and it is clearly proven that diversification does this.

To get the right mix and the right diversification, an investor's portfolio will be lined up with their goals. An investor who can afford higher risk will have a portfolio with a greater percentage of higher risk assets such as Equities and a lower percentage of lower risk assets such as Bonds and Cash. The opposite will be true for a lower risk investor.

In this respect a high risk portfolio may typically look like this:

Asset Class	Percentage of assets
UK Equities	40%
Overseas Equities	20%
Property	10%
Commodities	10%
Government Bonds Uk (Gilts)	5%
Government Bonds Overseas	5%
Corporate Bonds	5%
Cash	5%

A lower risk portfolio may typically look like this:

Asset Class	Percentage of assets
UK Equities	30%
Overseas Equities	5%
Property	10%
Government Bonds Uk (Gilts)	25%
Government Bonds Overseas	10%
Corporate Bonds	10%
Cash	10%

The key overriding aim of the asset allocation approach is to take a top down view, aiming to get the optimal mix of assets in place to meet an investor's risk.

It is because of this that rebalancing is so important. Because – unless the investor's objectives change and all other things being equal – then the optimal asset mix should not change. However performance differences (as evidenced in the example of the 50/50 investor at the start of this paper) can have the effect of taking the percentages away from the optimum position.

Rebalancing works because it does several things all at once:

- As described above it keeps the asset allocation mix aligned with the investor's risk position.
- It helps to reduce risk because in all probability a regular rebalancing of a portfolio will reduce volatility in the portfolio's fluctuating valuation (this is not guaranteed to happen, indeed rebalancing could increase volatility, but on the balance of probability and "normal" asset movements, it should reduce it). Reducing volatility is a proxy for reducing risk.
- It provides a mechanism whereby rising values in one asset class are grabbed (i.e. through selling) at regular intervals and exchanged for purchases in a reducing or underperforming asset class. This should provide a 'buy low, sell high' approach which is generally the opposite of what investors do – which is good because investors have historically suffered from buying assets going up and selling those going down.
- It provides an inbuilt discipline to review and renew the portfolio regularly ensuring that there is vigilance about the values and performance.

As an embedded part of an asset allocation strategy and approach, rebalancing can be considered essential. However this is mainly down to the fact that it keeps a portfolio lined up with the initial asset mix defined by the risk tolerance of the investor. It is therefore important to point out that if this risk position changes (which is likely over time, for example the risk approach of an investor preretirement may be higher than postretirement) the optimum asset mix may also change.

In addition, the market (and risk) position of certain asset classes may be reassessed. For example, many experts now consider Bonds to be higher risk in 2014 than they were in 2011, even though they represent a constant asset class. In this respect, things are constantly changing and this needs to be factored into any approach which includes rebalancing on a regular basis.

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What is a regular basis?

Assuming the basic rebalancing concept has now been explained, a crucial question still remains unanswered: how often should a portfolio be rebalanced?

This is a 'how long is a piece of string?' sort of question!

There is no right answer.

There are three possible ways that an approach can be taken here: one is to rigidly impose a rebalancing point, for example (as we used in our simple example above) once per year, but this could be once per two years or per three years, however long the period the point being it is regular and consistent; the second is to review regularly (for example once per year) and take a 'management view' each year, the investor and their adviser can decide whether to rebalance or not at that review point; the third is to rebalance based on asset movements, not timelines. This means only rebalancing when an asset has moved out of line by over (for example) 10%. If UK Equities are meant to be 30% of the total but because of asset movements they now represent 40% of the total then a rebalance takes place.

This is a fluid position, which can alter from adviser to adviser, from investor to investor. In this respect, it is about 'style' rather than any form of mandated methodology.

We believe, however, it is important to have an agreed approach and to include this approach in the overall financial planning adopted.

What about costs?

One of the concerns some people have with rebalancing is the question of cost isn't changing and switching assets on a regular basis a costly exercise?

Costs need to be factored in and naturally excessive or prohibitive costs avoided. However, modern investment platforms tend to allow for assets to be switched without cost or for limited cost. Different investors may use different types of investment to represent their asset holdings. Vehicles such as ISAs, ETFs, Pension funds and Investment Trusts are examples of the type of account or fund that may be used to hold the underlying investments. Often switches can be made within and around these types of investment without any significant cost.

It is important, though, that costs are considered and that the switching that is required by rebalancing does not become a costly exercise which could take away the benefit of having such a strategy.

In mentioning cost it is important to also mention the associated, similar, issue around tax. If instigating a change or a switch triggers a tax charge this could be a negative.

As with costs it is important to make sure that there isn't any punitive tax generated when a switch between assets is made.

These are two important factors to keep in mind and to be aware of in the context of rebalancing. However we are certain that in a majority of cases a successful rebalancing approach can be pursued and these factors managed accordingly.

That's the theory but does it work in practice?

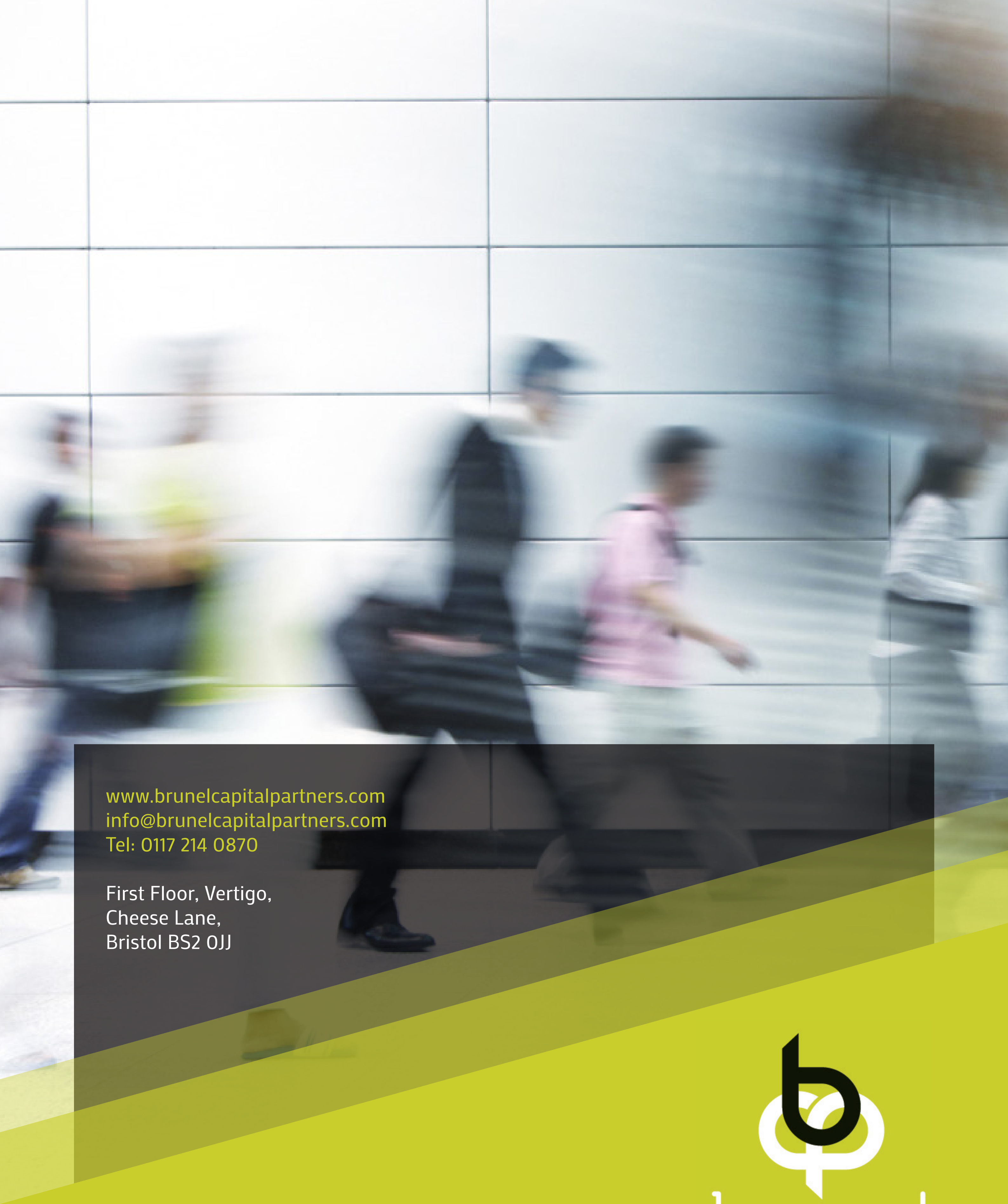
There is no categorical yes/no answer to apply here because as explained, rebalancing is dependent on the future returns pathway from a number of different assets. These variable possible future outcomes are many and amongst all the future possibilities there will be scenarios where rebalancing worsens the position (i.e. reduces the future investment value). However we believe that more often than not it will benefit investors who are looking to take a measured risk approach to their investing.

The bigger question is this: is there any empirical evidence that rebalancing is a positive? The happy answer is yes.

A study by investment company TIAACREF in 2002 viewed a portfolio started in 1992 and investing 49% in shares and 51% in bonds through the 10 year period. The rebalanced portfolio outperformed by around 0.4% per year but demonstrated much lower volatility and risk aspects. Further and more recent surveys and studies by the same group continue to produce the same conclusions.

Another study by authors Craig Rowland and JM Lawson between 1972 and 2011 – but based on an asset mix of shares, bonds, cash and gold (equally split) – showed a similar position, with the rebalanced portfolio producing 9.5% compared to the static portfolio's 8.8%. Again the volatility and risk on the balanced portfolio was lower, with much lower and fewer years where losses were incurred, during the period surveyed.

It appears that, in the main, rebalancing edges up returns and reduces risk on a typical portfolio.



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