Rebalancing a Portfolio

When should you rebalance a portfolio & what do you need to consider?

As markets gyrate, rise and fall, investors may question why adding exposure to the piece of the portfolio that is falling most is the right thing to do. Most of the time it's exactly the right thing to do, for the long run.

The one thing to remember is that rebalancing is all about managing risk. Rebalancing is not trying to get extra return (although that can result!) as the goal of rebalancing is to make sure the risk taken in the portfolio is appropriate with expectations. An under- or over-risk portfolio will behave differently from expectations so the key with rebalancing is building a process that you can stick to. So that means a process where there are no emotional decisions involved!

There are three main thoughts around rebalancing:

1. Do nothing
2. Rebalance on a regular time basis
3. Rebalance using a specific trigger or threshold

The main goal of rebalancing is to make sure you are taking the appropriate level of risk in your portfolio. Market moves can shift portfolio exposures and may put you at a higher, or lower, level of risk that you originally signed up for. So, keeping a close eye on the exposures can help to maintain the expected level of risk.

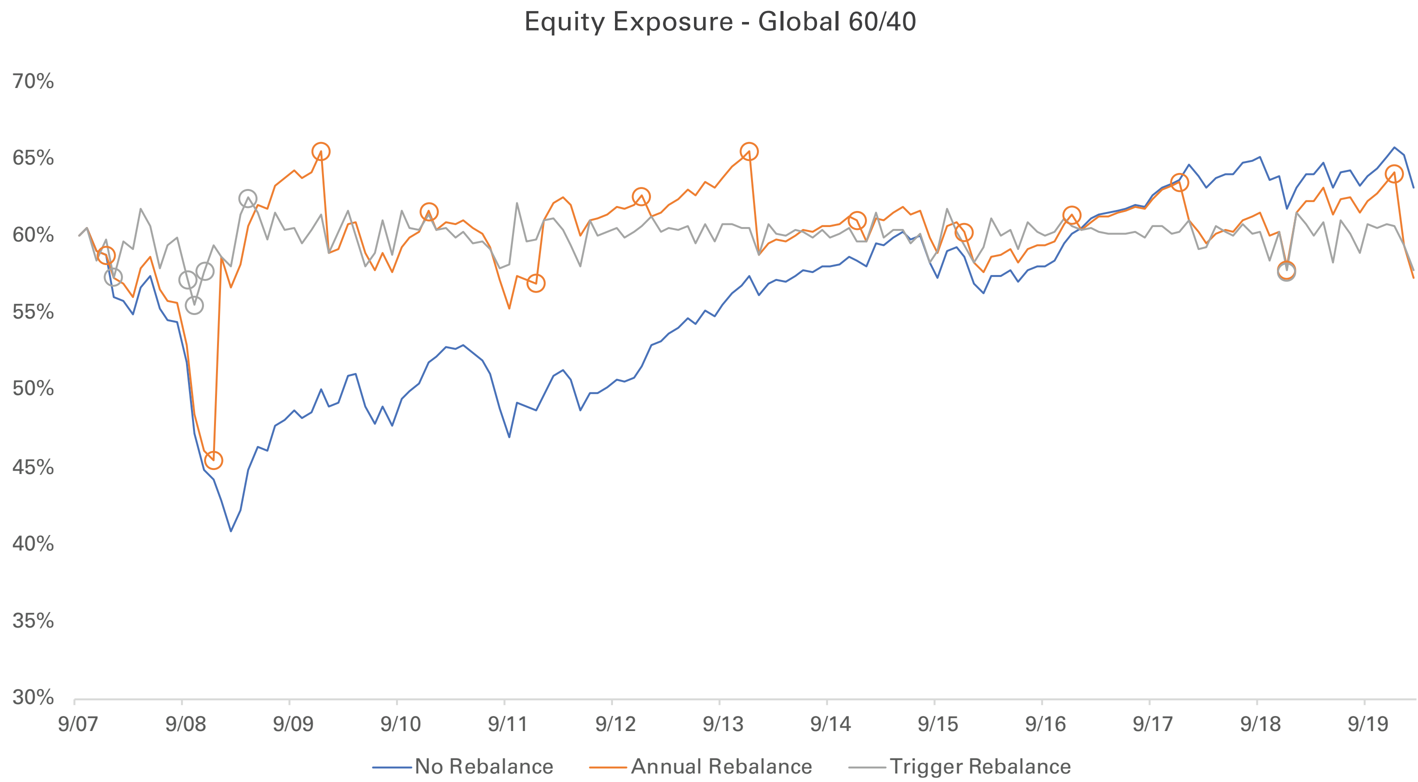
If you do nothing to the portfolio over time, you're setting the initial allocation and then letting the movements of the market drive it over time. Portfolios could shift down in risk exposure or up in risk exposure. This could change the risk experience of the portfolio. For example an investor in a 60/40 equity/fixed income portfolio at the beginning of 2020, would have seen its exposure shift to 51/49 by March 23.

Rebalance on a regular time period is rebalancing on a regular, periodic basis (e.g., quarterly, annually) back to its target weights. This method is simple and straightforward to execute but may experience periods of time when the portfolio has shifted substantially from its target allocation.

Rebalance using specific triggers requires a systematic approach to frequently check that exposures don't breach thresholds. First, the decision surrounds the threshold to use. Some use a simple +/-5% around target, but that might make some positions be very out of alignment if the original position was small. Some use a volatility-based threshold that takes into account the original exposure in the portfolio, for example larger exposures would have a wider threshold than smaller exposures. This appropriately sizes the threshold and aligns to the asset class by considering volatility. Higher-volatility equities would be allowed more range of exposure than lower volatility bonds.

To see the impact on a simple portfolio, let's look at a global 60% equities / 40% fixed income portfolio that was invested at the peak of the market in 2007. We calculated the impact of not rebalancing, doing annual rebalancing or using a volatility-based threshold for rebalancing.

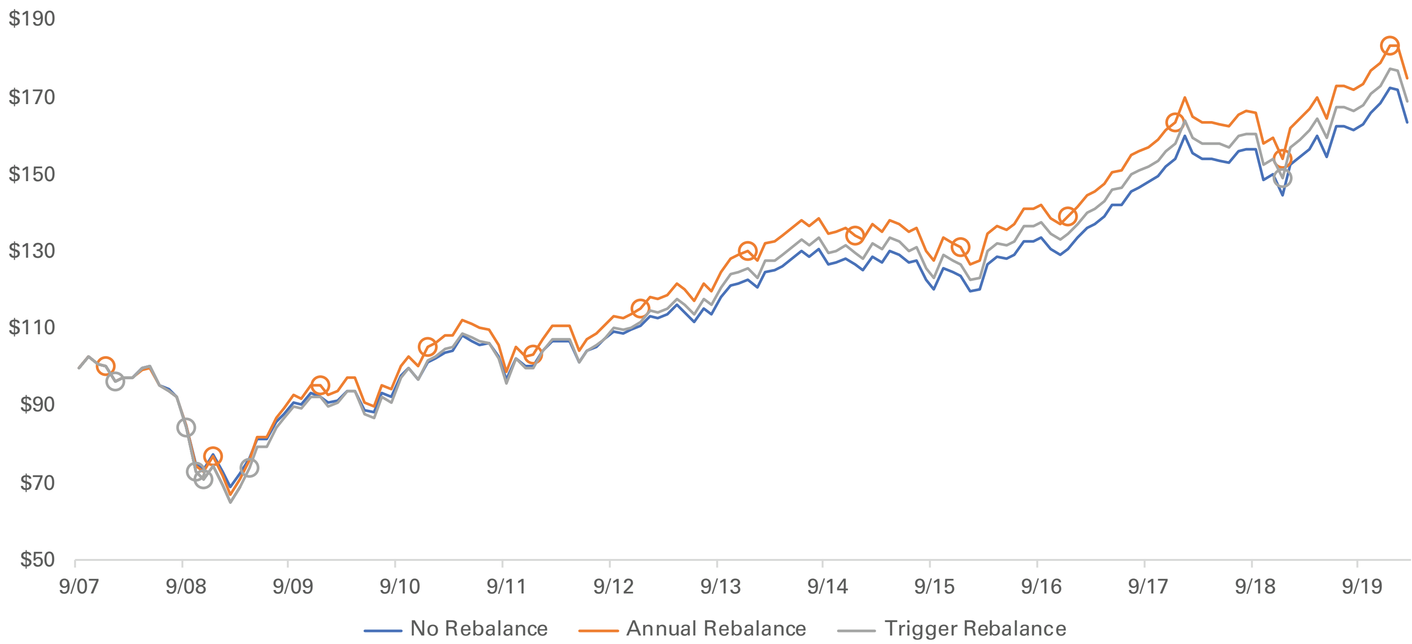
Annual rebalance was completed at the end of each calendar year, with 13 occurrences over this period. The threshold method saw fewer total rebalances, six over the period, but saw some higher frequency in episodes of market declines. In the chart below the circles represent the times that the portfolio was rebalanced.



Source: AssetMark, note: circles are times rebalance occurred.

Equity exposure over time is shown above and demonstrates that the No Rebalance portfolio had the greatest variance from its expected 60/40 portfolio allocation. The Annual Rebalance portfolio saw lower levels of variation than No Rebalance, but at times they were significantly different from the target. The Threshold Rebalance portfolio stayed closest to the original target portfolio.

Growth of $100K - Global 60/40 Portfolio



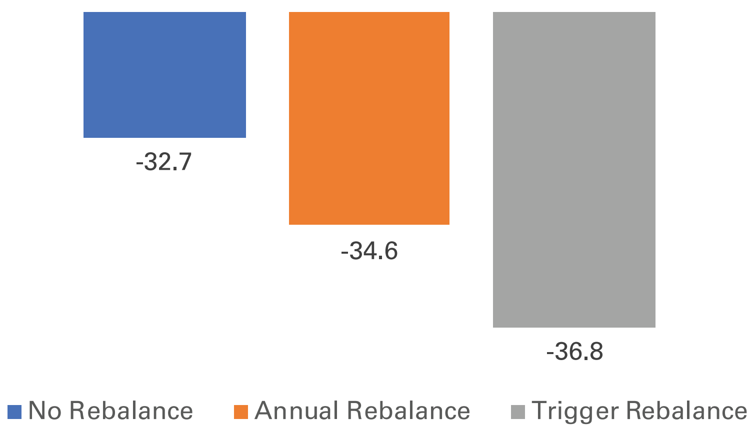
Source: AssetMark, note: circles are times rebalance occurred.

The chart above takes a look at how these portfolios performed over the time period.

Both of the rebalanced portfolios provided stronger relative returns, over the long term, than compared to the portfolio that was left to run. While this doesn't happen all the time, part of the reason is that, at times, portfolios were rebalanced after a period of equity weakness which was followed by a rebound. In rebalancing during periods of equity weakness, the portfolio adds equity exposure which benefits the portfolio in the subsequent rebound, but, may create greater losses in the near term if equity markets continue to fall.

During the market fall of 2008, the No Rebalance portfolio saw its exposure reduce significantly to 40%, creating a natural de-risking of the portfolio during that time. This led to a loss of 32.7% for the portfolio during the market fall from the high in October 2007 to the low in February 2009.

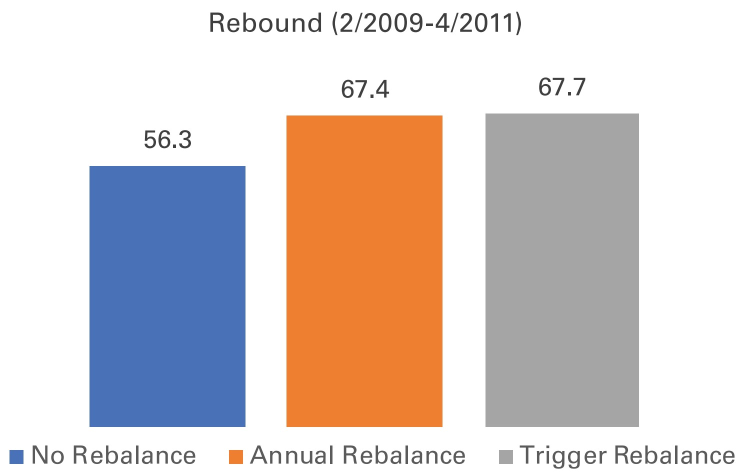
Drawdown (10/2007-2/2009)



Source: AssetMark

The portfolios that were rebalanced saw activity over that period and bought into equities as they continued to drop. In this case, the rebalance process was adding risk to their portfolio as the markets fell, so the Annual Rebalance portfolio fell by 34.6% and the Trigger Rebalance portfolio fell by 36.8%. This is a reminder that the goal of rebalancing is not about producing a level of return, but risk managing to the risk profile.

Despite the bigger drawdown during the market fall, the Trigger Rebalance portfolio positioned itself into a larger equity exposure so when the rebound occurred it benefited from the rally and outperformed the No Rebalance portfolio over the longer time period.



Source: AssetMark

Rebalancing a portfolio is an important process to managing a client's risk in their portfolio. Times of market decline or gain likely increases the discussion around rebalancing and what is the right thing to do. Some key considerations when choosing your rebalancing approach are: the time needed to monitor the portfolios, the cost involved of trade execution and the cost of people needed to oversee the process.

Remember, the goal of rebalancing is around portfolio risk and making sure the portfolio is taking the appropriate level of risk. It is not about trying to produce a higher-level return, although this can be a nice side effect of rebalancing over the long-run!

Strategists on the AssetMark platform use their own processes to determine whether their portfolios need to be rebalanced, including AssetMark Guided Solutions. The processes described in this piece can apply to both rebalancing across asset classes and also across strategists combined into a portfolio.

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