Russell Investments

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The Rebalancing Reward

A successful investment strategy begins with an asset mix that best fits personal goals and preferences. Such a target asset mix is designed to offer investors the highest expected risk-adjusted return consistent with their individual risk tolerance.

Fluctuations in the capital markets can shift portfolios away from their original asset allocation targets, causing the composition of a portfolio to change in ways that may increase risk.[1] As a result, it is important to monitor investments and restore portfolios back to original target allocations. This process is known as rebalancing, a critical yet sometimes misunderstood aspect of investing.

Rebalancing is one of the important keys for effective risk management. According to a study by Ibbotson Associates, if an investor had 60% in stocks and 40% in bonds, and over the past 25 years rebalanced this mix at least annually, they would have reduced their risk by 25%.[2] Despite the potential rewards, some investors may ignore rebalancing, primarily due to their uncertainty regarding this relatively simple procedure. In light of these concerns, investors may find it helpful to consider the following factors:

1. How rebalancing works
2. Why rebalancing is necessary
3. The benefits of rebalancing
4. When to rebalance
5. The costs of rebalancing

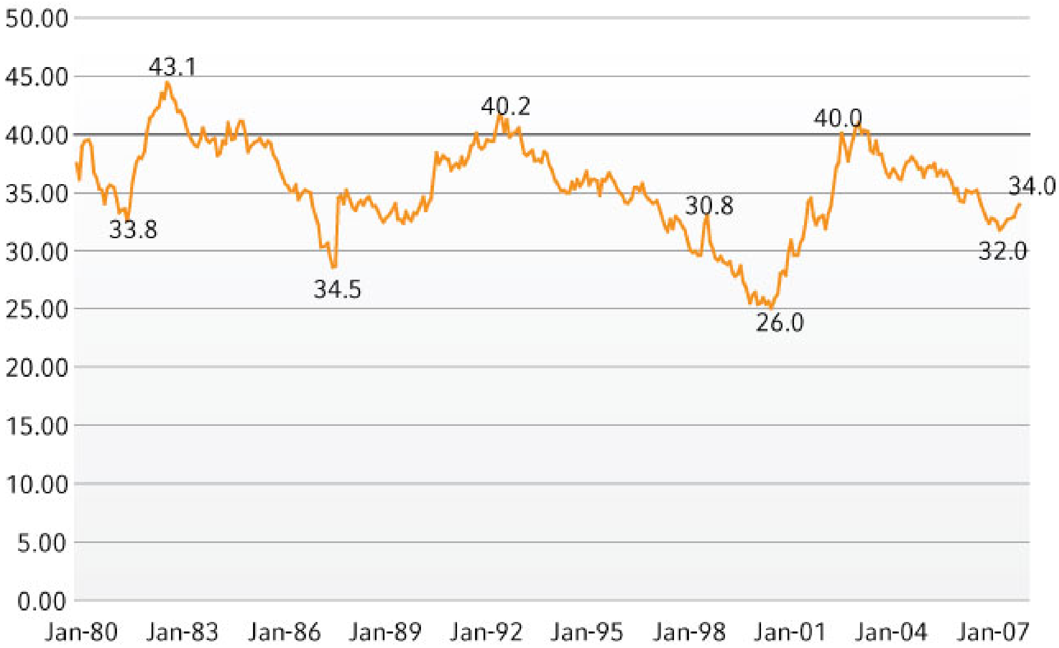
1. How rebalancing works

Rebalancing forces investors to trim back on winners and increase undervalued assets—a principle of the "buy low, sell high" theory. If an asset class becomes overvalued, an investor who rebalances will be selling it as it rises; and if an asset class becomes undervalued, the investor will be buying it as it falls. In contrast, someone who invests 60% in stocks and 40% in bonds but never rebalances would likely have the highest percent of their portfolio in the overvalued asset class at its market peak and the lowest percent of the portfolio in the undervalued asset class at its market trough.

Figure 1 illustrates this point by indicating how an investor's allocation to fixed income changes over time if not rebalanced to the initial allocation. Starting in 1980 with a 40% allocation to fixed income, this weighting drifts from a high-point of 43.1% in September 1982 to a low-point of 26.0% in August 2000.

Figure 1:
Original Portfolio Asset Mix: 40% Fixed Income (DEX Universe Bond Index), 30% Canadian Equity (S&P/TSX Composite Index), 15% US Equity (S&P 500 Index), 15% Foreign Equity (MSCI EAFE Index).

Figure 1: The Consequences of Not Rebalancing (Jan. 1980 to Dec. 2007)



Source: Russell Investments Canada Limited

2. Why rebalancing is necessary

Why is rebalancing important? In the face of rising volatility, maintaining a balanced and diversified portfolio is important as a risk control measure. Unfortunately, some investors still question whether or not they need to pursue a regular rebalancing strategy.

By trying to avoid risk, investors may actually end up increasing it. Over the long run, as returns on different assets lead or lag each other, their portfolios will be transformed accordingly. The percentage of shares, or "weights", allocated to outperforming asset classes will tend to rise. Underperforming asset classes will tend to shrink. As a portfolio becomes more concentrated, it can grow top-heavy, and vulnerable to volatile changes in the market.

Many investors learned this lesson the hard way in the bull market of the 1990s and in the market declines that followed. During the bullish period, making money appeared to be easy and investors tended to put rebalancing on the back-burner. Because many failed to establish a rebalancing policy, several years of rising equity prices left portfolios extremely heavy with US large-cap stocks, particularly technology stocks. This tilt greatly magnified losses during the subsequent bear markets.

3. The rewards of rebalancing

Aside from helping investors maintain their asset allocation and reducing risk, there are several other benefits of rebalancing.

Helps investors stay within their comfort zones

An unrebalanced portfolio can potentially stray from an investor's accepted level of risk and jeopardize their long-term goals. Rebalancing keeps an investor's portfolio inline with their stated objectives and ensures that the investor does not take on more risk than they can tolerate, in either the upswings or the downswings of the market.

May enhance returns

The rebalancing process requires investors to sell assets that have appreciated in value, and buy assets that are temporarily out of favour. It can be argued that a sound rebalancing strategy may have a positive impact on portfolio returns, at least over the long run.

While risk management is the primary reason for pursuing a rebalancing strategy, it may also enhance returns to some extent. Russell compared the excess return and tracking error (versus a target benchmark) of six portfolios. Each were rebalanced using a different strategy—e.g. at certain time periods and threshold levels—against a portfolio with a buy-and-hold strategy. The rebalancing comparison ran from January 1979 to March 2003. Over this time period, the rebalanced portfolios had greater annualized excess returns than the unrebalanced portfolio. More significantly, the tracking error or risk associated with the rebalanced portfolios was cut by more than half.[3] While these results are time-period dependent, they do suggest that rebalancing does have the potential to enhance returns and dramatically lower portfolio volatility.

Rebalancing also tends to reinforce one of the main benefits of portfolio diversification: the tendency of returns on different assets to offset each other over time. Because the returns of a balanced portfolio are less volatile, this allows the magic of compound growth to work more quickly, potentially boosting long-term returns.

4. When to rebalance

In recent years, investment professionals have debated a variety of rebalancing strategies versus a buy-and-hold approach. Such strategies include: rebalancing semi-annually; rebalancing annually; or rebalancing at a deviational trigger point (e.g. 2.5%).

According to the results in Figure 2, it appears that there is little difference in the annualized returns among the three different rebalancing scenarios.

Figure 2: A Comparison of Rebalancing Strategies (Jan. 1980 to Dec. 2007)

Rebalancing Type	Buy & Hold	Semi-Annually	Annually	2.5% Bond/ Stock Drift
Annualized Return	10.6	11.3	11.2	11.4
Annualized Risk	10.9	10.4	10.4	10.4

Source: Russell Investments Canada Limited

Figure 2: Original Portfolio Asset Mix: 40% Fixed Income (DEX Universe Bond Index), 30% Canadian Equity (S&P/TSX Composite Index), 15% US Equity (S&P 500 Index), 15% Foreign Equity (MSCI EAFE Index).

The key is that simply rebalancing a portfolio yields a superior risk-adjusted return to that of a non-rebalanced portfolio.

Figure 2 also points out that there isn't a single, optimal rebalancing method. It doesn't seem to matter when investors rebalance their portfolios because each rebalancing method produces a similar risk/return profile.

5. The costs of rebalancing

For many investors, transaction costs and tax consequences will play a role in determining whether they pursue a rebalancing strategy.

Tax consequences are an issue for investors in non-registered portfolios and will, most likely, enter into their rebalancing decision. For example, if a client has a sizable unrealized capital gain, he or she may choose to forgo rebalancing over a shorter-term period until such time as his or her tax situation is more favourable.

The common sense solution to this issue is that whenever possible, an investor should use new cash flow to bring their portfolio back to its target asset mix. This is easily done through a periodic PAC (pre-authorized chequing) plan—which does not trigger any taxable consequences.

Rebalance with Russell

In some instances, the rebalancing equation must not only cover the allocation of funds among asset classes but also among money managers as well. Fortunately, the Russell Sovereign Investment Program and LifePoints Portfolios both feature portfolio monitoring, asset allocation advice, and renowned manager research capabilities to decide how funds should be re-allocated among a line-up of the world's leading money managers.

Russell offers strategically designed combinations of carefully selected money managers. Each manager is an expert in a particular investment style. Managers are then combined into investment pools, structured around a specific benchmark with the objective of minimizing systematic biases (i.e. risk exposure) to any one sector or style.

Russell typically invests new cash flows into the pools to ensure that the actual weights of the underlying money managers are as close as possible to their targets. For example, Russell will normally direct new cash flow to the manager that is the most underweighted relative to their target. Using cash flow in this manner has the advantage of lowering transaction costs (versus moving cash from one manager to another) and does not distract the managers with small, frequent contributions.

As financial markets fluctuate and investment climates change, investors need a strategy that can weather these changes and still provide a solid opportunity to achieve their goals. Therefore, it would be wise to speak to an advisor and re-examine the value that rebalancing can bring to a portfolio. Without a rebalancing strategy, investors could end up with portfolios that are significantly out of line from their initial risk and return objectives.

Rebalancing summary checklist:

- ✔ May lower volatility
- ✔ Follows "Buy Low, Sell High" Principle
- ✔ May enhance risk-adjusted returns
- ✔ Tax consequences of rebalancing can be minimized through a PAC plan or other cash contributions
- ✔ Use Russell programs which offer a higher level of rebalancing within its investment pools

[1]Risk is defined as the standard deviation of the return on total investment, or the degree of uncertainty of return on an asset.

[2]Ibbotson Associates, 2003. The study used a portfolio of 60% large-cap stocks, as represented by the S&P 500 Index, and 40% bonds, as represented by the Intermediate Government Bond Index, from1978 through 2002, rebalanced annually.

[3]Bouchey, Paul-"How To Create A Rebalancing Policy", Russell Investments, June 2003.

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