DIARY OF A PORTFOLIO MANAGER

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“Patience is a key element of success” –Bill Gates

The Importance of Portfolio Rebalancing

Establishing a disciplined rebalancing strategy is an essential part of professional portfolio management. While many investors intuitively know this, some may question its merits versus a buy and hold approach. The following may help you better understand why a consistent rebalancing methodology is important to achieve the objectives established at portfolio onset (while dealing with the practical challenges such as implementation and taxes). Investors spend time determining a long-term asset allocation strategy that will provide an optimal return/risk trade-off reflective of goals. Rebalancing is a process by which assets are bought and sold in order to maintain this long-term target asset allocation.

Note that I did not include all the charts with performance numbers of how various asset classes have done over different time frames. Should that be of interest, call me and we can discuss.

Portfolio management theory suggests that an investment plan can be successful when it is accompanied by a regular review of position weights and the implementation of a disciplined rebalancing strategy. As asset classes and styles within the classes tend not to always move together, imposing a rebalancing discipline can help manage the impact caused by large swings in the markets that can generate periods of emotion and uncertainty for investors.

Investors may appreciate the theory of rebalancing yet they may question whether it really makes a difference in practice. We take a closer look below at why investors struggle with this question, how rebalancing can make a difference for portfolios, and what investors should consider when thinking about their own approach. From a practical standpoint, rebalancing can be done at the asset class level, the sub-asset class level, and at the individual security level. For purposes of this commentary, we will consider rebalancing only at sub-asset class levels.

Why investors struggle with the concept of rebalancing

The positive impact of rebalancing can often get lost on investors in the short-term. A rebalancing strategy for a balanced portfolio is unlikely to outperform a buy and hold strategy for the duration of a strong bull or trending equity market; but when the market upturn reverses, rebalancing can work to mitigate equity losses that will follow.

Equity returns have dominated fixed income returns over the past 5 years; a buy and hold strategy may very well have outperformed one with rebalancing. Naturally, investors have questioned the merits of a rebalancing strategy and some may have even abandoned their approach. However, looking at 10-year numbers (which include the financial crisis of 2008), maintaining a consistent allocation to fixed income would have been important. This is illustrated by the fact the returns for both asset classes were similar over this longer term period.

I should add that in the current environment of rising rates, fixed income has and may continue to struggle in the short term but will still exhibit very low volatility especially when compared to equities.

Rebalancing Considerations

The bottom-line conclusion RBC reached through studies of the impact of rebalancing on volatility and returns is that it matters. But there are nuances and important issues that investors should consider depending on their particular situation. I highlight some of the key findings below:

- Rebalancing has bigger impact in multi-asset portfolios
- Rebalancing seems to be most beneficial for multi-asset class portfolios.
- Narrow tolerance bands in a rebalancing strategy lead to more attractive risk-adjusted returns for more conservative profiles while higher tolerance bands may benefit more aggressive profiles.

- A 5% tolerance band could generally be seen as a reasonable approach so as to provide a balance between risk and cost control, minimizing excessive rebalancing transactions.
- Annual rebalancing may be most effective and practical
- Enhanced returns and reduced risk were generally seen whether rebalancing was implemented quarterly, semi-annually or annually.
- Transaction costs don't meaningfully alter the positive impact of rebalancing
- Even after transaction costs are considered, rebalancing portfolios still has a positive impact.
- Taxes matter
- Taxes are a key factor that investors have to deal with. Tax-sensitive clients may benefit from a less frequent rebalancing approach or an approach with higher tolerance bands.

Final Words

Over the long-term, the implementation of a disciplined portfolio rebalancing strategy can enhance portfolio returns. More importantly, rebalancing can work to reduce portfolio volatility and smooth the investment experience for clients, creating a consistent plan of action to help better achieve financial objectives. Furthermore, a process that includes reasonable thresholds and frequency can be adopted by investors to ensure limited tax consequences and ease of implementation. As a result, we have a strategy where portfolios are rebalanced regularly.

If you have any questions about this or your financial plan, please do not hesitate to contact me anytime at 613-566-4582. Corrie can be reached at 613-566-2032 and Jason at 613-566-7547.

As always, thank you for the opportunity to serve you and your family.

Todd Kennedy
Vice President and Portfolio Manager

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