



Wealth Management
Dominion Securities

Strike a balance: The importance of portfolio rebalancing

Establishing a disciplined rebalancing strategy is an essential part of portfolio management. While many investors intuitively know this, there are many that question its merits versus a buy-and-hold approach. We explain how rebalancing is key to achieving one's unique financial objectives while dealing with challenges such as implementation and taxes.



Investors spend a substantial amount of time determining a long-term portfolio asset allocation strategy that can provide an optimal return/risk trade-off reflective of their investment goals. Rebalancing is a process by which assets are bought and sold in order to maintain this long-term target allocation.

Portfolio management theory suggests that an investment plan can hold better prospects for success when it is accompanied by a regular review of position weights (relative to long-term target allocation) 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.

Many investors appreciate the theory of rebalancing; yet they often question whether it really makes a practical difference. 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.

Rebalancing can be implemented at the asset class level, the sub-asset class level, and at the individual security level. For our purposes, we will consider rebalancing only at the sub-asset class level.

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 (i.e., like we have had in recent years). But when the market upturn reverses, rebalancing can work to mitigate any equity losses that may ensue.

Returns to the end of December 2017 illustrate this point (see "Point-in-time returns and volatility comparison" on the following page). Looking at performance for the trailing 5-year period, equity returns dominated fixed income returns; a buy-and-hold strategy may very well have outperformed one with rebalancing. Naturally, investors may have questioned the merits of a rebalancing strategy and some may have even abandoned their approach.

However, when looking at 10-year numbers (which include the financial crisis of 2008), we can see that maintaining a consistent allocation to fixed income would have been important. This is illustrated by the fact that returns for both asset classes were similar over this longer-term period. More importantly, a consistent allocation to fixed income provided exposure to an asset class with much less volatility, making for a smoother investment experience for investors.

Point-in-time returns and volatility comparison

Canadian fixed income and equity at the end of 2017

	5 years		10 years	
	Fixed income	Equity	Fixed income	Equity
Cumulative total returns (1)	16.0%	51.3%	57.8%	57.5%
Annualized returns	3.0%	8.6%	4.7%	4.7%
Annualized volatility (2)	3.8%	8.2%	3.7%	15.5%

Data as of December 31, 2017

(1) Aggregate amount the benchmark returned over the defined period of time.

(2) Measured by standard deviation, a measurement of the variance of portfolio returns from its average.

Source - FactSet, Zephyr Style Advisor, Returns in CAD based on indexes representative of each asset class: Canadian Fixed Income: FTSE TMX Canada Universe Bond Index; Canadian Equity: S&P/TSX Composite Total Return Index. Numbers rounded to one decimal. Hypothetical performance based on the returns of indexes. Indexes are unmanaged and used as a broad measure of market performance. It is not possible to invest directly into an index.

Rebalancing makes its mark during market inflections

We return to a key statement in the section above: “when the market upturn reverses, rebalancing can work to mitigate any equity losses that may ensue.” The same can be said on reversals of market downturns.

In essence, rebalancing makes its mark when trending markets change course.

To illustrate this point, we take a look at a simple example: a Canadian balanced asset mix that was established in 1999 with no rebalancing strategy. The table below shows how long-term asset mix targets can easily change, even within relatively short-term windows. There was significant drift in the target asset mix (60% / 40%) from one year to the next. For example, within two years of starting, the portfolio had shifted to a 66% / 34% asset mix, only to change to a 56% / 44% asset mix two years later. Drift significantly adjusted again from 2007 to 2009.

It may seem counterintuitive to sell securities that have appreciated and purchase those out of favour. A rebalancing strategy that focuses on keeping an asset mix near target can help portfolios prepare for the downside during bull markets by buying more fixed income. Conversely, it can help prepare for the upside during bear markets by buying more equities. Rebalancing reinforces the “buy low, sell high” principle, maintaining a consistent plan of action that removes any consideration of market timing, and allows gains to be crystallized along the way.

As per the bottom table, using the same hypothetical Canadian balanced portfolio, an annual (year-end) rebalancing strategy added value relative to a buy-and-

How asset allocation can change when a portfolio is *not* rebalanced

Changing asset mix of buy-and-hold Canadian balanced portfolio

Asset class	Jan. 1999	Q1 2001	Q1 2003	Q1 2005	Q1 2007	Q1 2008	Q1 2009	Q1 2011
Equity	60%	66%	56%	62%	68%	69%	59%	67%
Fixed income	40%	34%	44%	58%	32%	31%	41%	33%

Hypothetical portfolio. Based on 60% Canadian Equity (S&P/TSX Composite Total Return Index) / 40% Canadian Fixed Income (FTSE TMX Canada Universe Bond Index); period beginning Jan. 1, 1999. Numbers rounded.

Source - FactSet, Zephyr Style Advisor, Returns in CAD are based on indexes representative of each asset class: Canadian Fixed Income: FTSE TMX Canada Universe Bond Index; Canadian Equity: S&P/TSX Composite Total Return Index. Hypothetical allocations based on the returns of indexes. Indexes are unmanaged and used as a broad measure of market performance. It is not possible to invest directly into an index.

Performance of a Canadian balanced portfolio around periods of crisis

Rebalancing strategy	Returns during Tech Wreck (%)				Returns during Global Financial Crisis (%)		
	2000	2001	2002	2003	2007	2008	2009
Buy and hold	8.35	-5.57	-4.22	17.89	7.86	-20.84	22.76
Annual	8.54	-4.31	-3.97	18.71	7.37	-17.23	23.20

Hypothetical portfolio. Based on 60% Canadian Equity (S&P/TSX Composite Total Return Index) / 40% Canadian Fixed Income (FTSE TMX Canada Universe Bond Index); period beginning Jan. 1, 1999.

Source - FactSet, Zephyr Style Advisor, Returns in CAD are based on indexes representative of each asset class: Canadian Fixed Income: FTSE TMX Canada Universe Bond Index; Canadian Equity: S&P/TSX Composite Total Return Index. Hypothetical performance for allocation based on the returns of indexes. Indexes are unmanaged and used as a broad measure of market performance. It is not possible to invest directly into an index.

hold strategy both in bear markets (2001–2002; 2008) and subsequent periods when equity markets recovered (2003; 2009).

Rebalancing considerations

A study of the impact of portfolio rebalancing on returns and volatility confirms that it matters (see Disclosures on page 4 for information about these models). There are nuances and important issues that investors should take into account when choosing a rebalancing strategy. Some key considerations and best practices:

Rebalancing has a bigger impact on multi-asset portfolios

Rebalancing seems to be most beneficial for multi-asset class portfolios. Risk-adjusted returns were less differentiated for Equity-only/Equity-focused portfolios, especially during extended periods of equity market strength.

“Tolerance bands” are more important for more conservative strategies

Consider tolerance bands (absolute percentage change from target allocation) to inform rebalancing decisions. Narrow tolerance bands can lead to more attractive risk-adjusted returns for more conservative profiles, while wider 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 the most effective method. Enhanced returns and reduced risk were generally seen whether rebalancing was implemented quarterly, semi-annually, or annually. The most attractive risk-adjusted returns followed annual rebalancing, which also resulted in less potential rebalancing trades.

Taxes matter

Taxes are a key factor that investors have to deal with. Tax-sensitive investors may benefit from a less frequent rebalancing approach or an approach with higher tolerance bands. Both will lead to lower portfolio turnover that could decrease the potential for realizing capital gains. One should always be cognizant of adverse tax consequences of buying or selling securities when rebalancing. It is important to recognize the ability to utilize tax losses to offset realized capital gains (or vice versa) so as to potentially neutralize the tax impact of a rebalancing strategy.

The bottom line

Over the long term, a disciplined portfolio rebalancing strategy may enhance portfolio returns. More importantly, rebalancing can reduce portfolio volatility and smooth the investment experience for investors, creating a consistent plan of action to help achieve financial objectives.

A rebalancing policy that includes reasonable thresholds and regular reviews can minimize tax consequences and improve the effectiveness of an investor’s portfolio strategy. We recommend that portfolios should be evaluated for rebalancing at least once a year. More frequent evaluations would be appropriate during more volatile markets, as asset allocations may deviate quickly from target ranges.

Disclosures and disclaimers

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Rebalancing models

In 2012, a series of investor risk profiles (Strategic Asset Allocation Models) were created within RBC Dominion Securities to meet an array of investment objectives that balance risk, return, and time horizon. Five Canadian International (globally focused, but recognizing Canadian biases for domestic investors), five Canadian Domestic (Canadian-biased), and five U.S.-focused (non-Canadian) model portfolios were created.

The rebalancing study compared the benefits of various scenarios based on the strategic asset class weights within the five profiles (Very Conservative, Conservative, Balanced, Growth, and Aggressive Growth) for the Portfolio Advisory Group's Canadian International, Canadian Domestic, and U.S. Asset Allocation Model Portfolios. Each model had defined long-term targets for Cash, Fixed Income sub-asset classes (i.e., government, corporate, and high yield), and Equity sub-asset classes (i.e., by geography). Very Conservative profiles are considered the lowest risk (focusing on capital preservation with high allocations to fixed income), while Aggressive Growth profiles carry the highest risk (focusing on maximization of long-term capital appreciation with an all-equity approach).

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