A Time To Rebalance?

With the price of crude oil at record levels in the last year, energy stocks and the funds primarily invested in them have been enjoying a tremendous run. At this time, investors are essentially faced with two choices: They can rebalance by selling some of their holdings that have done well to buy those which have done less well, or they can allow their portfolios to drift significantly away from the original asset allocation targets. Unfortunately, many investors are tempted to let their well performing investments ride; however, over the long-term, we have found that a rebalancing strategy is more effective to achieving your investment goals.

If history teaches any lessons, it is that the only certainty in the financial markets is change. In financial markets, what goes up invariably must come down - making performance chasing a dangerous strategy. Over time, market conditions can be expected to fluctuate dramatically as industries, sectors and entire asset classes pass in and out of favour. Many investors learned this the hard way during the bull market of the 1990s and in the steep declines that followed. Failure to rebalance after several years of rising equity prices had left portfolios vulnerable to losses during the subsequent bear market. It is important to remember – rebalancing will occur – either you do it, or the market will undertake this task for you. One has much better implications for the investor!

Following a disciplined rebalancing strategy involves purchasing securities or funds that have under performed and selling securities or funds that have performed well over the investment period. This ensures that investors follow the principle of buying low and selling high and, if done properly, can help reduce unintended portfolio risk and enhance return.

Having said this, for many investors, the rebalancing process can feel unnatural as emotions often dictate holding successful investments for too long, while, at the same time, selling weaker investments before they have the opportunity to recover.

Following a disciplined rebalancing process helps control emotions, even in trending markets, where the benefits of rebalancing may be less evident, by ensuring that a portfolio remains aligned to its intended asset allocation. In addition to controlling emotional investing, rebalancing also serves to reduce overall portfolio risk. 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%. Rebalancing ensures that a portfolio is in line with its stated objectives and that there is not any undue exposure to additional investment risk. Another benefit of rebalancing is the reduction of tracking error risk, which, like costs, increases as the portfolio drifts farther away from its target asset allocation. Tracking error is a measure of the volatility of returns around a specified benchmark and is quadratic, as the deviation from the benchmark doubles, tracking error quadruples. For instance, if a portfolio with a 40% target allocation to Fixed Income rises to 42% Fixed Income, 2% over target, the tracking error is four times higher. At the same time, as tracking error increases, so does the risk that the portfolio will not achieve returns that are in line with the underlying portfolio benchmark. This means that the portfolio may significantly underperform (or outperform) its benchmark.

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Rebalancing in Action

Imagine an example where a portfolio consists of only two stocks in equal weights. During the first period of time, Stock A outperforms Stock B. At the end of this period, we rebalance back to a 50/50 weighting. We are therefore forced to sell a portion of Stock A, which has just performed well, and reinvest the proceeds into the underperforming Stock B. In the second period, Stock B outperforms Stock A. This time we sell part of our holdings in B to purchase A, restoring back to the 50/50 weighting.
Of course markets will not deliver a smoothly alternating set of returns from period to period. Sometimes we may see the same stock (bond, fund, etc.) run for more than one period. This will most likely shorten the rebalancing cycle. But over time, we should see the short-term leadership reversing between Stock A and Stock B on a regular basis - even if, in the longer term, one shows cumulative performance materially better than the other. Unless the long-term differential is very large, the rebalanced portfolio will likely keep pace with, and may outperform, a portfolio where the asset mix is allowed to drift.

Rebalancing – When?

To take emotion out of the investment decision, it is necessary to have clear rules about when to rebalance and under what conditions. Your Investment Policy Statement should help direct the decision of when to rebalance back to your strategic asset allocation. Rebalancing annually, quarterly, or when an allocation strays outside a preset range will provide a good opportunity to achieve a long-term return objective, and even enhance returns, while maintaining your risk profile.

The Bottom Line

It is easy to get caught up in the excitement surrounding the energy sector and it is tempting to chase recent returns. A disciplined rebalancing strategy, based on written goals and asset allocation targets, can play defense to these urges while helping you manage risk and achieve your investment goals.

For more information on rebalancing or to discuss your current asset allocation strategy, please contact us.

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