

Rebalancing Act

How can you persuade clients to reallocate?

By John Nersesian



ONE OF A PLANNER'S MOST DIFFICULT tasks in getting clients to implement a financial plan is convincing them to rebalance their asset allocations. Clients often have emotional attach-

ments to their investments that make rebalancing uncomfortable, regardless of how productive it can be. And, let's face it, liquidating assets that have gone up and adding money to classes

that have done poorly is counterintuitive. Before you can persuade clients to rebalance, you have to show them the benefits. The argument that is probably easiest for clients to hear and get excited about is the one that shows how rebalancing can potentially provide a better return at less risk than a buy-and-hold strategy.

For example, we did a study over 20 years with a hypothetical \$1 million portfolio divided into five asset classes (see "A Portfolio Divided" on page 110). In the 20-year period from January 1985 to December 2004, the return on a buy-and-hold portfolio was \$8,874,742, with a standard deviation or volatility of 13.6%. When the same portfolio was rebalanced annually it provided a return of \$9,324,229, with 11% volatility. The bonus from rebalancing: \$449,487—with 19% less risk (see "The Rebalancing Edge" on page 110).

DIFFERENT STYLES

What is the best rebalancing method? There are four primary choices: periodic, range, threshold, and mid-point threshold. Of the four, periodic and threshold are the most commonly used.

Periodic rebalancing is done on a regularly scheduled date, such as annually, quarterly or semiannually.

Range rebalancing takes place when the portfolio violates a certain preset tolerance limit. For example, in your policy statement you might have established that a client will have an exposure to equities of 50% to 55%. The allocation can bounce around within that range, and you would only readjust the holdings if the allocation rose above or fell below the limits of the range.

Threshold rebalancing is based on a specific percentage target, say 50%. You might let the allocation exceed that target in either direction by various percentages, but when you rebalance, you would always bring it back to exactly 50%.

In the *mid-point threshold* method, instead of rebalancing back to the initial target, you would only shave assets

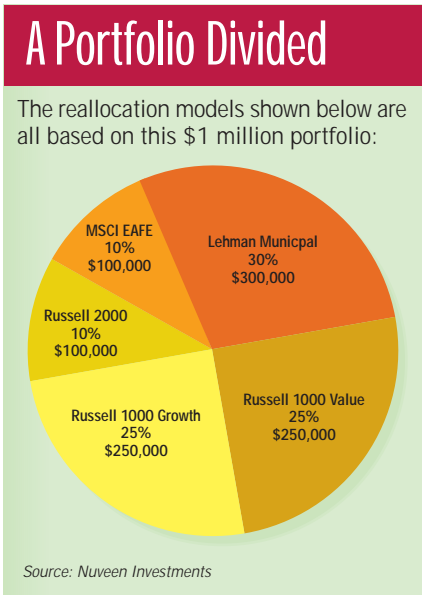
halfway back, thus leaving some over-exposed positions in the portfolio. With an initial target of 50%, a portfolio that appreciated to a 55% equity allocation would be pared back to 52.5%. Instead of selling off all the excess gains, this method accommodates the cyclical runs of certain asset classes, which may outperform over several years. While this technique provides a potential extra performance boost, it may also expose clients to additional risk.

WHERE MANY ROADS LEAD

Which is the best method? We took our five-asset \$1 million portfolio (at right) and studied all four methods from 1985 to 2004. We compared monthly, quarterly, semiannually and annually rebalanced returns for the 20-year period. The table “Comparing Techniques” on page 113 shows that readjusting a portfolio quarterly yielded slightly better results than the other periods. But the difference between the quarterly return and the next best result, for the annually rebalanced portfolio (11.86% versus 11.81%), was very slight.

Quarterly rebalancing may have provided the best results, but when you compare it with rebalancing annually, the quarterly return was just a hair higher and the risk just a tad lower. Therefore, it may not be worth the extra effort to rebalance quarterly, especially since more frequent adjustments can rack up additional tax and transaction costs. Annual rebalancing may make more sense.

A small downside to the annual approach is that the allocation has a longer time to get out of whack. But that kind of tracking error typically matters much more to institutional investors than to retail clients. Moreover, rebalancing annually at the end of the year gives the adviser and the investor an opportunity to meet and discuss the year’s tax-sensitive planning. They can strategize together over which gainers and losers to sell depending on whether they need to generate capital losses or gains.



For each rebalancing technique, we also calculated the risk-adjusted return—that is, the risk you pay to achieve that return, determined by the Sharpe Ratio (return minus the risk-free rate of return divided by standard deviation). This is a better

way to compare the ongoing consistency of returns.

When we compared range rebalancing for various ranges from +/-2% to +/-20%, the 20% range yielded an annualized return of 12.29%, significantly better than the 11.91% return of the 2% range, for a \$673,547 rebalancing bonus. But that higher return came at a significantly higher risk. The wider percentage range and less restrictive rebalancing policy degraded the consistency of returns (a standard deviation of 12.70 versus 11.88).

In fact, on a risk-adjusted basis the 2% range fared best over the 20 years, with a Sharpe Ratio of 6.41 versus 6.29 for the 20% range. Notable is the poor performance produced by rebalancing in a 10% range, which returned only 10.28% with a standard deviation of 12.42%, for a Sharpe Ratio of 4.82. But given that exception, the risk-adjusted returns of the other ranges were extremely close.

When using the threshold method,

The Rebalancing Edge

The benefits of rebalancing versus a buy-and-hold strategy with the assets in the \$1 million portfolio shown above are demonstrated both before and after taxes.

20 YEAR PERIOD - JANUARY 1985 TO DECEMBER 2004

BEFORE TAXES			
	Without Rebalancing	Annual Rebalancing	Rebalancing Bonus
Ending Value	\$8,874,742	\$9,324,229	
Increased Return from Rebalancing	→		\$449,487
Standard Deviation	13.6%	11.0%	
Reduction in Volatility	→		19.2%
AFTER TAXES			
	Static Portfolio, After Taxes	Annual Rebalancing, After Taxes	Difference
Ending Value	\$8,087,986	\$8,258,964	
Increased Return from Rebalancing	→		\$170,978
Standard Deviation	13.6%	12.0%	
Reduction in Volatility	→		12.0%

Source: Nuveen Investments

the 20% range fared best on both a raw return and risk-adjusted basis, earning \$238,891 more than the next highest return (2% range) with relatively little increase in volatility. Once again the 10% range fared poorly. The earnings results from the mid-point rebalancing method increased somewhat with increasing range. But the risk-adjusted returns for different ranges were virtually identical.

In the end, the numbers appear so similar for each method that it matters much less which approach you use than that you stick to some regular rebalancing plan.

THE TAX IMPACT

The case for rebalancing is clear with pretax returns. But what about after-tax returns? We reran all the numbers assuming that when you rebalance the indexes in the portfolio, a certain percentage of assets would have to be sold and would generate a gain.

We assumed sales of 20% of the Russell 1000 Value allocation, 40% of the Russell 1000 Growth, 10% of the Lehman Municipals, 40% of the Russell 2000 and 35% of the MSCI EAFE at the end of each year. We “taxed” 30% of those sales proceeds at the long-term capital gains rate of 15%. The result: Even though taxes took a significant bite out of returns, there was still a sizable rebalancing bonus of \$170,978.

Of course, rebalancing won’t work without adequate diversification. It’s the noncorrelated moves in the portfolio’s various asset classes that have the potential to create the greatest return benefit. At the same time, rebalancing is a strategy that can significantly reduce risk.

It’s important to remember that rebalancing doesn’t work all the time; it works over time. Many advisers suffered the groans of frustrated investors during the 1990s. When the markets kept rising and just about all growth stocks looked like winners, it was particularly painful for clients to sell those winners—which they thought would never stop climbing—and buy losers

Comparing Techniques

The rebalancing method you choose has a measurable effect on both risk and return. Here are five methods for managing a \$1 million hypothetical portfolio over 20 years. (For the portfolio allocation, see “A Portfolio Divided” on page 110.) For each technique, we highlighted the tolerance range that produced the best risk-adjusted return.

SCENARIO 1: BUY AND HOLD

	Avg. Annual Return	Standard Deviation	Sharpe Ratio	End Value
Static Portfolio	11.53%	13.57%	0.533	\$8,874,742

SCENARIO 2: PERIODIC REBALANCING

Rebalance back to original target at end of preset time period.

	Avg. Annual Return	Standard Deviation	Sharpe Ratio	End Value
Annual	11.81%	10.96%	0.685	\$9,324,229
Semiannual	11.74	11.96	0.622	9,202,243
Quarterly	11.85	10.87	0.695	9,391,171
Monthly	11.76	10.93	0.683	9,241,189

SCENARIO 3: RANGE REBALANCING

Rebalance when the allocation deviates beyond a certain tolerance range, and bring the allocation back within the range instead of to the original target.

Tolerance Range	Avg. Annual Return	Standard Deviation	Sharpe Ratio	End Value
+/- 20%	12.29%	12.70%	0.629	\$10,165,760
+/- 10%	10.28	12.42	0.482	7,084,423
+/- 5%	11.77	12.00	0.622	9,251,217
+/- 2%	11.91	11.88	0.641	9,492,213

SCENARIO 4: THRESHOLD REBALANCING

Rebalance when the allocation deviates beyond a certain tolerance range, and bring the allocation back to the original target.

Tolerance Range	Avg. Annual Return	Standard Deviation	Sharpe Ratio	End Value
+/- 20%	11.98%	12.14%	0.632	\$9,606,430
+/- 10%	11.78	12.12	0.617	9,279,388
+/- 5%	11.84	12.02	0.627	9,367,539
+/- 2%	11.83	12.00	0.627	9,355,587

SCENARIO 5: MIDPOINT REBALANCING

When assets move beyond the threshold, rebalance to the midpoint of the range.

Tolerance Range	Avg. Annual Return	Standard Deviation	Sharpe Ratio	End Value
+/- 20%	11.95%	12.14%	0.632	\$9,562,071
+/- 10%	11.90	12.01	0.633	9,470,144
+/- 5%	11.85	11.96	0.631	9,395,948
+/- 2%	11.84	11.96	0.630	9,371,851

Source: Nuveen Investments

that went nowhere. The problem is that one never knows when the cycle will change—and that idea may be more convincing to clients than the idea of buying losers. But because you’re adding more money to the asset classes that are cheapest, you are likely to be repaid eventually.

John Nersesian, CFP, CIMA, CIS, is managing director of Nuveen Investments Wealth Management Services Group in Chicago. He can be reached at john.nersesian@nuveen.com.



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