Porter, White & Company

What Do We Do Now – Rebalance?

Investment Commentary, August 8, 2011

During the past week, the US government narrowly avoided default on its obligations, the financial markets declined precipitously on poor economic news, Standard & Poor's downgraded its credit rating on the US debt from AAA to AA+, and the S&P 500 Index opened down and fell over 3% on the Monday morning after the news of the downgrade.

Equity markets have sold off precipitously in the last few weeks leaving many investors wondering how they should react. Some might want to sell everything and move to cash while others might want to "double down." Under most of our investment policies, big market movements in one direction or another typically trigger rebalancing of a portfolio's equity and fixed income holdings. In this commentary, we explore some of the reasons why an investor might want to rebalance and the rationale behind that decision.

I. Background

As of Friday's close, the S&P 500 index is down almost 10% for the quarter, and more than 10% from its high during the year. A globally diversified portfolio with relatively more small and value stock holdings is down slightly more. The strongest returns are in intermediate term government bonds, particularly inflation protected securities, with the 10 year treasury rate dropping from 3.18% at the beginning of the year to below 2.5% currently.

With this kind of volatility (or more accurately, dispersion in returns among stocks and bonds), most portfolios with a meaningful amount of bonds will now have more bond (and less stock) exposure than called for in the applicable investment policy.

II. Considerations

Just because a policy adopted months or years ago triggers a rebalancing does not mean that an investor should automatically rebalance. We typically want to ask investors a few questions.

A. Has anything changed in your circumstances since we adopted this policy?

While the movement in the market may cause us to want to take action, we believe that it is the investor's specific circumstances that should drive any decision. Changes in individual circumstances may require changes in the investment policy that have nothing to do with market events. Some changes may be related to macro events (ie, loss of job, government contracts, etc.), but many times they are unrelated.

B. Are you comfortable with the risk position of the rebalanced portfolio?

We always ask clients if there is a value that you do not want your portfolio to fall below. We use fixed income to reduce risk, and so the amount of the bond holdings is particularly important. For example, a client may not want their bond holdings to fall below a certain level, say $1 million. If so, that would reduce the amount of any rebalancing, but may not rule out all trading since most bonds have performed well.

C. What transaction costs are involved? (i.e., Capital Gains)

For non-profit, retirement plan and individual retirement accounts, taxes are not an issue and the trading costs are usually not material. For individual clients who have built in long term gains, the cost of rebalancing would require realizing long term gains, and these costs have to be weighed against potential benefits. This analysis is typically more involved and very specific to each client.

III. Rationale for Rebalancing

There are a number of reasons that we recommend rebalancing, but the primary reason is to encourage investment discipline and reduce risk over the long term. We have reviewed a number of studies on rebalancing weighing the benefits of rebalancing at different frequencies, but have concluded that risk management should fundamentally drive a rebalancing decision as well as the ability of portfolios to recover (if in fact, markets do recover).

In rising markets, rebalancing to fixed income allows investors to build their safe assets. The best time to reduce the risk of an asset allocation policy is when an investor is close to reaching a specific goal or dollar value for a portfolio. (This, of course, assumes that such a goal is specified in advance.) Unfortunately, it is rare that an investor is meeting a goal in a down equity market unless there is unexpected income from another source.

IV. Are We Speculating?

We avoid speculating and do not believe in tactical asset allocation, which is typically defined as making changes in allocation based on changing predictions of the short term performance of the components of a portfolio. Equity markets are very noisy, and we believe that engaging in this type of speculation rarely leads to good long term risk adjusted performance.

A rebalancing strategy like the one we use is often referred to as "contrarian" as it involves selling the winners and buying the losers. It is important to remember that the market does not know what your target policy is (nor does it care). It does not know when the last time you rebalanced or if anything else has changed in the interim. The reason why the rebalancing is done is, therefore, very important.

V. Concluding Thoughts

We always tell our clients that their portfolios will do well if the world does well. In the short term, there is a lot of uncertainty and risk. In the long term, the returns on our portfolios are driven by fundamental economic growth. Growth is not inevitable, but capitalism, which is based on the assumption that markets work, has performed pretty well over time. Any decisions to change an investor's portfolio should be driven by their own circumstances, and not by speculation on the future.

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VI. IMPORTANT NOTICE

i. Past performance is not a guarantee of future results. Values change frequently and past performance may not be repeated. Even a long-term investment approach cannot guarantee a profit. Economic, political, and issuer-specific events will cause the value of securities, and the portfolios that own them, to rise or fall.

ii. Indices are not available for direct investment; therefore, their performance does not reflect expenses associated with management of an actual portfolio.

iii. Historical performance results for investment indices, or categories, generally do not reflect the deduction of transaction or custodial charges or the deduction of an investment management fee, the incurrence of which would have the effect of decreasing historical performance results.

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v. Economic factors, market conditions, and investment strategies will affect the performance of any portfolio and there are no assurances that it will match or outperform any particular benchmark.

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