

Your portfolios keeping in shape



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Regular rebalancing is vital to maintain a healthy portfolio. Graham Bentley explains why.

New Year, new you. Men all over the country will have an alcohol-free January (rather than simply cutting down), and some will even take to exercise (remember a gym isn't just for January). Expensive detox programmes and other nutritionist mumbo-jumbo will occupy many, despite their (free) liver and kidneys doing the job perfectly adequately. We will all resolve to be thinner/bigger/fitter/carbon neutral, but for the most part plus ça change...

January is our 'rebalancing' month. We attempt to get ourselves back to par, if only because we know our bodies will get out of kilter as the year progresses. Much like our varying waistlines, an investment portfolio that is matched to a client's risk profile at the start of the year may look very different by December, owing to differences in returns of the underlying funds. It is important to consider how these changes in portfolio emphasis should be handled, and we know that process as rebalancing.

The need for portfolio rebalancing is now generally acknowledged. There are various rebalancing strategies, but the common thread which runs through most of them is the fact that they are generally focused solely on returns, rather than risk management. This leads inevitably to a debate about the frequency of rebalancing; how often should the rebalancing process be performed, in order to optimise returns? Surprisingly perhaps, little attention has been paid to rebalancing frequency in the academic

literature. One piece of theoretical analysis by Efficient Frontier LLC suggested that no one rebalancing period consistently produces superior results. Depending on the total investment period chosen, different rebalancing frequencies win out; optimisation outputs will be very different for data obtained from monthly, quarterly and annual sampling from within the same historical period. However, the research has limited meaning in the real world, because most of the testing has been done on asset pairs, eg US equities versus US bonds. Most portfolios are relatively complex, involving both local and foreign equities and bonds, along with Property.

For a complex portfolio, any 'returns-focused' rebalancing benefit is contingent upon three factors: the volatility of the portfolio assets (the more volatile, the better), the correlations of the portfolio assets (lower correlations mean higher rebalancing returns), and the differences in returns among the assets. The most recent work on complex multi-asset portfolios attempts to find a formula which accurately predicts the extra returns generated by selecting a certain frequency of rebalancing, or 'rebalancing bonus'. Some preliminary results seem to suggest that shorter rebalancing intervals may not always be optimal, but that's as far as it goes. For almost all periods studied there is an improvement as the rebalancing period increases, except that there seems to be little

difference between annual and quarterly rebalancing. You should expect this, because asset class returns are not a perfect random walk; there is overwhelming evidence that there is short-term persistence in asset class returns, so it is a good idea not to be too hasty buying and selling.

An alternative to calendar rebalancing is threshold rebalancing. In other words, instead of regularly rebalancing, one waits until the portfolio gets a certain amount out of position before adjusting it back to policy, ie rebalancing portfolios when a target return has been reached. However, this can also present a problem. Tiny changes in the threshold are critical; whether your threshold for bonds or equities was barely reached, or barely missed, immediately prior to the 1987 'Crash' made a huge difference. The rebound since March 2009 is another example.

Finally, one extreme minority faction believes that portfolios should be 'let run', ie no rebalancing, on the basis that interfering with this acts as a drag on performance. This group has, belatedly, also borrowed a key tenet of behavioural finance – the idea that investors have a psychological bias which pressures them to sell their winners and hang on to their losers, which over time depresses performance. They believe that the whole effect of rebalancing is to take profits and buy losing positions. This of course ignores the real point of rebalancing – risk management.



the benefits of rebalancing

We recently analysed the performance and volatility of a portfolio that was rebalanced annually compared with one that was not rebalanced over a period of ten years. The portfolio was derived from our U-Select tool back in 1999 which created a medium risk asset allocation. The results were compared to the performance and volatility of the FTSE® 100 and balanced managed sector average.

Although different market conditions over the last ten years would have produced different results, based on sector average performance for each asset class within the portfolio, the overall investment would have returned 56.29% over the ten-year period when rebalanced annually, compared to 40.29% if not rebalanced. As a comparison, this compared to a return of 24.76% for the balanced managed sector and 6.20% for the FTSE® 100.

In terms of volatility, the rebalanced portfolio had a volatility figure of 10.75% which was the lowest out of the four elements analysed. Again, different market conditions over the ten years would give a different outcome for the volatility scoring too, but this data shows that rebalancing a portfolio back to the investor's agreed asset allocation each year helped ensure the portfolio's volatility was controlled and, most importantly, remained in line with the investor's agreed risk profile.

Past performance is not a guide to future performance.

rebalance to manage risk

The hard fact is that for different periods, within which different asset behaviours have been in evidence, and for different asset mixes, different return outcomes would have resulted depending on rebalancing strategy. However worthy, proponents of all these approaches may, in reality, have missed the point about risk. When constructing investment portfolios, many advisers ask their clients what return they require, and then tell them they have no alternative but to accept the level of risk commensurate with that return. An alternative approach is to consider investors' attitudes to gains and losses. Psychological studies have demonstrated that from an investor's viewpoint, losses hurt roughly twice as much as equivalent gains feel good. Investors' expectations are therefore skewed; risk (ie potential for loss) dominates most people's investment philosophy, not return. Logically therefore, advisers should establish a client's risk profile first, and then inform them of the variability of expected returns associated with that risk level.

Now, the benefits of rebalancing are more obvious, for both the client and the adviser. If a portfolio was a risk level 5 a year ago,

changes in asset class weights (eg if equity returns outstrip bonds and property) it may now be a risk level 8, and no longer in tune with the client's own risk profile. Consequently rebalancing back to the appropriate risk profile is paramount. Investment disasters can be blamed on the vagaries of the market, but if the portfolio carries too much risk due to a lack of diligent rebalancing, the client may opt for litigation rather than commiseration. In a now infamous drawdown case, an adviser recommended a 'Balanced Managed Fund' for an apparent medium risk investor, presumably assuming that as balanced was somewhere between active and cautious, and his client was somewhere between high risk and low risk, he was making the perfect match. However, the fund was 80% equity and when the valuation fell dramatically and the client sought damages, the ombudsman found in his favour. The cost to the adviser was £100,000.

how often should the risk level be reviewed?

In the absence of definitive evidence, there is one other factor which should be considered – tax. Frequent rebalancing of a portfolio which is liable to CGT can be an

administrative nightmare. Another issue is cost. Frequent rebalancing involves transaction costs to varying degrees, which are themselves a drag on returns.

Taking all these factors into account, I believe there is a very strong case for rebalancing to be no more frequent than on an annual basis. Annual rebalancing is a good discipline, because it provides an agreed point at which risk is reassessed, yet allows assets which have momentum to run their course over a reasonable period. It has the practical benefit that the less frequent the trading, the less costs are likely to be a burden, and finally CGT planning and calculation are simpler on an annual basis than for quarterly, and certainly monthly periods.

Alternatively, in a risk-rated fund, such as Skandia's Spectrum range, you can be confident that the fund is constantly monitored to avoid breach of volatility targets. Furthermore, since activity within the fund is CGT free, Spectrum's internal trading and rebalancing activity does not attract CGT. This might present an ideal solution for those clients whose ISA portfolios need to be knocked back into shape in time for the tax-year end. If only maintaining a health and fitness regime was as undemanding. ●

Find out more about the benefits of Skandia's Spectrum funds at tax-year end at skandia.co.uk/cupoftea

www.skandia.co.uk

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