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Rebalancing: A Return Enhancer, Risk Reducer, Both or Neither?

By Ian A. Post, CFA

Rebalancing *is the process of realigning the weightings of a portfolio of assets. Rebalancing involves periodically buying or selling assets in a portfolio to maintain an original desired level of asset allocation.*

Source: Investopedia: http://www.investopedia.com/terms/r/rebalancing.asp

Rebalancing is generally considered a best practice in portfolio management. If you believe that the starting point for portfolio design is to match a portfolio to the investor's willingness and ability to accept volatility risk, then rebalancing is a necessary procedure that maintains the strategic allocation to risk. Without rebalancing, the portfolio asset allocation will drift over time, becoming riskier if equity markets go up and stocks become an increasing percentage of the portfolio, or less risky if stocks decline and bonds subsequently become a larger portion of the portfolio. In either case, the riskiness of the portfolio drifts over time and no longer matches the investor's demand for risk.

As a byproduct, rebalancing changes the realized return and volatility of the portfolio when compared to a true Buy-and-Hold strategy. There are varying claims about what rebalancing does to realized returns. Some claim a "rebalancing bonus" based on the idea that rebalancing forces a "sell high, buy low" process that increases returns over time. Others point out that since stocks have generally gone up over time, that systematically rebalanced portfolios will always underperform Buy-and-Hold portfolios because they hold a smaller percentage of stocks over time.

The reality is that the impact of rebalancing on returns depends on how the underlying asset classes perform over the holding period. If stocks do better than bonds, a rebalanced portfolio will have lower returns than the Buy-and-Hold portfolio and vice versa. We can see this by looking at two recent periods.

Bonds do Better Than Stocks, September 2007 through March 2009

Over the period encompassing the financial crisis of 2008 (market peaked in September 2007), a 60/40[1] Rebalanced[2] portfolio delivered a total return of -28% vs -34% for the Buy-and-Hold portfolio with an annualized return more than four percent higher and 13% less volatility.

Stocks do Better Than Bonds, April 2009 through May 2016

Over the subsequent period coming out of the financial crisis, a Buy-and-Hold 60/40 portfolio delivered a total return of 102% versus 97% for the Rebalanced 60/40 portfolio. The annualized return was 10.3% for the Buy-and-Hold versus 9.9% for the Rebalanced. The Rebalanced portfolio volatility was 13% lower than the Buy-and Hold.

The analysis shows some interesting results. First, the impact on total return is driven by how stocks perform. Stocks do better, Buy-and-Hold does better and vice versa. Second, volatility was lower for the Rebalanced portfolio during ***both*** periods. The reduced volatility made the ride smoother and, importantly, improved *annualized* (growth of wealth) return by reducing variance drain[3].

Lastly, by definition, the Rebalanced portfolio maintained consistent risk exposure while Buy-and-Hold risk exposure varied significantly over time.

So is rebalancing a:

- Return Enhancer? Sometimes
- Risk Reducer? Yes

While rebalancing does not consistently enhance returns, it does provide benefits important to investors. It maintains consistent portfolio risk exposure, lowers volatility and improves annualized returns relative to average returns by reducing variance drain.

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[1]60% allocation to the MSCI World Index (equity) and 40% allocation to the Barclays US Aggregate Bond Index. [2]Rebalanced monthly. [3]Variance Drain is the difference between Geometric (Annualized/Growth of Wealth) Return and Arithmetic (Average) Return. An investment that generates the same return each year will have equal Geometric and Arithmetic Returns. As variance increases, the Geometric Return decreases relative to the Arithmetic Return.