How We Rebalance Core Model Portfolios

NorthLanding Financial Partners, LLC
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Executive Summary

Portfolio rebalancing is a concept that we believe may be misunderstood by most investors. Its primary goal is to efficiently maintain a portfolio's initial asset allocation over time, without excessive trading or unnecessary costs and taxes. It must be executed with discipline over long periods of time to be effective. Rebalancing events are defined either by time, drift from a target percentage, or a hybrid approach using both time and drift. NLFP uses a hybrid approach that monitors our Core Model Portfolios' asset class weightings semi-annually and rebalances using a 5% corridor width threshold, in most cases. We believe that research on the topic indicates that our process is in accordance with best practices for rebalancing. Further, we believe that, over time, following these best practices will very likely result in superior risk adjusted returns vs. similar portfolios using less efficient rebalancing methods.

Portfolio rebalancing is a concept that is mentioned frequently in financial media and touted by both financial advisors and investment marketing materials. Unfortunately, many references to portfolio rebalancing fail to clearly illustrate the process or its benefits. While everyone has heard of it, many investors may not have a good understanding of what rebalancing actually is.

So what does portfolio rebalancing *really* mean?

Does it mean that an investment manager practicing rebalancing will change holdings rapidly, based on an opinion of how different sectors of the market are relatively over or under-valued? Or, similarly, if a manager has identified the next investment fad, that rebalancing would mean overweighting that? Quite to the contrary, portfolio rebalancing is not at all a tactical exercise and certainly does not involve having a predictive crystal ball. While seemingly savvy, "fast money" strategies that are often discussed on CNBC, such as market timing or high speed trades of individual securities, sound exciting, they are more likely to do harm than good by increasing both risks and costs. Many of these techniques are more akin to gambling or playing "Portfolio Bingo" than genuine "Portfolio Rebalancing."

Instead, portfolio rebalancing is simply a matter of restoring a portfolio's initial asset class weightings after the markets' movements have blown them off course. After all, these initial asset class weightings were carefully established and personalized through a comprehensive financial planning exercise (like our Financial Clarity Advantage Process) so it is important to maintain a portfolio that is reflective of that process. Hence, the primary goal of a rebalancing strategy is to ensure that a portfolio is consistently reflective of its initial expected return, expected risk, and diversification objectives over time. Portfolio rebalancing is a time-tested and mechanical principle of investing that one could argue is rather boring. In our opinion, however, boring can be beautiful, and well-informed clients tend to agree.

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Rebalancing to target allocations also provides discipline that can be particularly valuable during times of extreme volatility. For example, investors who did not rebalance their portfolios during the financial crisis may well have missed out on substantial subsequent equity returns.

So how exactly can portfolio rebalancing be accomplished?

Historically, portfolios have been rebalanced by either using a *set time schedule* or by frequently monitoring the *magnitude of changes* in the relative mix of asset classes, like stocks and bonds. These techniques are more formally known as **Calendar Rebalancing** and **Corridor Width Rebalancing**. Both are common techniques, but neither is perfect.

Calendar Rebalancing Method

How often should a portfolio that uses a calendar method be rebalanced? Using a monthly increment, for example, would result in less drift from the target asset allocation. However, this could result in excessive rebalancing that could dampen return by increasing trading costs, while producing only negligible changes in the portfolio mix. In fact, Vanguard's 2010 research on the topic concluded that rebalancing monthly between 1926 and 2009 would have resulted in 1,008 rebalancing transactions *without any increase* to a portfolio's risk adjusted return versus using a quarterly or annual method[1].

So if monthly is too much, what about annually? While an annual "calendar-only" method would reduce the excessive rebalancing in the example above, it historically has been less effective at maintaining desired target allocation, expected risk, and expected return[1].

For example, consider a calendar method that chooses to rebalance annually on January 1st. The market suffers a severe correction in March, only to fully recover by September. You may have ignored a significant rebalancing opportunity (to sell high & buy low) simply by the whims of an arbitrary, calendar-based method. Hey, after all, it's not January 1st, so annual calendar rebalancing (in this example) means there's nothing to do regardless of how much volatility your portfolio may experience in the other 364 days of the year. While its simplicity may be attractive, annual calendar rebalancing may be far from ideal, particularly in volatile markets.

Corridor Width Method

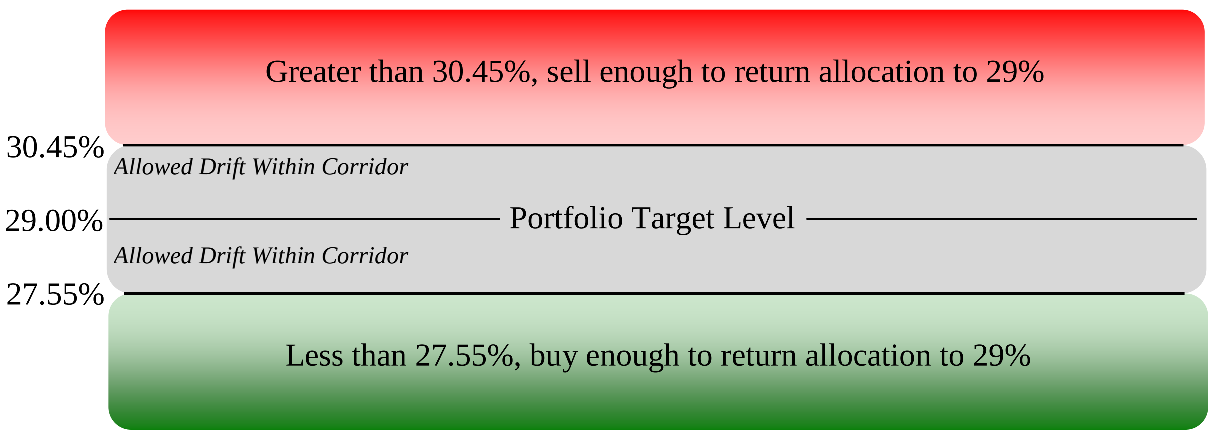
One way to alleviate the problem in the last example is to monitor Corridor Widths. Unlike calendar-only rebalancing methods, corridor width rebalancing incorporates information about the current allocation and characteristics of the assets in the portfolio. Corridor width rebalancing permits assets to drift above or below their target allocations within a predetermined range. So how would it work if U.S. large cap stocks, for example, represent 29% of a portfolio with a 5% corridor width?

The ceiling of the corridor would be 30.45% of the portfolio (target percentage of 29.0% x 1.05 = 30.45%). The floor would be 27.55% (target of 29.0% x 0.95 = 27.55%).

So the 5% corridor width establishes the range within which this asset class can be allowed to float: between 27.55% - 30.45% of portfolio value.

Example:

U.S. Large Cap Equity Exposure, Target Allocation of 29% and a 5% Corridor Width:



One other benefit of corridor width rebalancing is that, unlike most calendar rebalancing methods, it does not necessarily rebalance every asset class in the portfolio simultaneously. If domestic large cap stock has drifted outside its corridor, then it should be sold down to its target. However, if the international large cap equity weighting is within its corridor, then no action is taken for that particular asset class.

However, corridor width rebalancing makes no reference to time, so how *often* should these widths be monitored? Monitoring the portfolio and the determinants of corridor widths on a daily, weekly, or even monthly basis would involve micro-management that would be likely to increase portfolio trading costs and dampen returns. Simply put, over-monitoring the portfolio would be too much of a good thing.

So what is a practical solution?

Our conclusions on best practices for portfolio rebalancing

We believe a hybrid strategy that involves monitoring both the time between rebalancing events (Calendar Rebalancing) and the magnitude of changes (Corridor Width Rebalancing) is most effective and practical. Using a 'time and corridor width' hybrid method means we look at the percentage variations of assets in a portfolio, but only trade if they move outside their corridors, not simply because a certain amount of time has passed.

This requires ongoing diligence that most investors may not have the skill or patience to execute. Moreover, we believe that using a professional asset manager will keep investors from making emotional mistakes that prevent most from rebalancing consistently and counter-intuitively, as they must, for rebalancing to be effective. Specifically, as part of the portfolio construction and ongoing monitoring process, NorthLanding Financial Partners Core Model Portfolios' asset weightings are monitored *semi-annually* and most asset classes are rebalanced using 5% corridor widths. We believe that this provides a solution that maintains the objectives of the portfolio efficiently over time.

Because all rebalancing events may involve some level of transaction costs, Core Model Portfolios use many iShares index funds and load-waived mutual funds that have no transaction fees to purchase or sell. In fact, as of this writing, 17 of the 23 components of these portfolios have zero transaction costs associated with buying or selling them through our institutional custodian, Fidelity[2]. Recognizing that cost always matters, we monitor the transaction expenses of any rebalancing activity carefully.

As with many things in life, "the devil is in the details." While portfolio rebalancing may seem to be a simple and straightforward activity, "How," "When," and "Why" to do it are questions that can prove to have complex answers. While the answers may be complex, we want our clients to be as well-educated as they can or choose to be, based on their personal level of interest in understanding investment concepts. We believe this is important, specifically, because clients who have a high level of understanding and trust in the investment process tend to be more patient, disciplined, and successful investors over time.

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Reader Feedback: Did you find this article helpful? Are there other topics of interest or questions you have? We welcome your feedback to: **melissa@NorthLandingfp.com**

Sources:

1. Vanguard Research: Best Practices for Portfolio Rebalancing, July 2010.
2. Fidelity Institutional Wealth Services.