Rebalancing During a Time of Crisis: Any Different than Normal?

June 2020

OVERVIEW

- **Global equities were hit hard during the first quarter of 2020, erasing most of 2019's gains.**
- **Credit-oriented fixed income was also hit, but to a lesser extent, while US Treasury bonds performed well.**
- **Investors may find portfolios out of balance relative to target allocations. Is now the time to rebalance?**

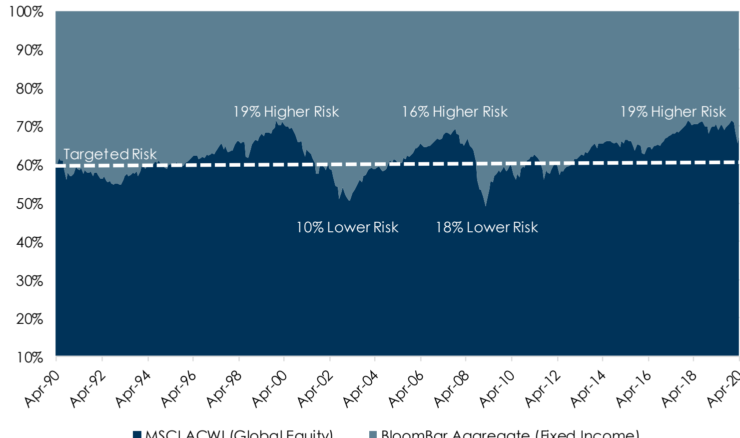
Background

Portfolio asset allocations are generally set at two levels: Strategic (longer-term) and Tactical (shorter-term). These allocations normally have bands around the particular asset class targets, allowing for some drift before rebalancing is required by policy. Monitoring actual asset allocation is a responsibility of the governance structure and may occur on a regular calendar-oriented schedule or on a more ad hoc basis. Although it's fairly difficult for meaningful drift to occur if asset classes trend in the same direction, the underlying concept of portfolio diversification suggests periodic episodes of imbalance should be expected. The Global Financial Crisis (GFC) of 2008 and the recent experience with COVID-19 both coincided with relatively extreme market movements, and resulted in questions surrounding the timing and magnitude of optimal rebalancing policies. Understanding the consequences of rebalancing (or not) can help drive the appropriate strategy for a particular pool of assets. But there is admittedly a lot of gray area in this subject, so having "the answer" is not nearly as important as understanding the tradeoffs.

Goals of Rebalancing

Before answering the question of how or when to rebalance, we believe it's necessary to understand the "why." Both strategic and tactical allocations have risk/return objectives or goals associated with them. Absent any rebalancing, the risk/return profile of an invested portfolio will fluctuate through time, such that the new profile may not be consistent with the original intentions of the asset pool. In the illustration below, we have shown the 30-year evolution of a hypothetical portfolio that began with 60% Global Equity and 40% Fixed Income. When allowed to drift, the asset mix and thereby its anticipated level of risk cycled within a range of nearly +/- 20% versus target. Although a drifting portfolio is not necessarily a negative scenario, it does change the risk/return profile. Rebalancing simply brings the structure back into line with the expectations established when the allocation was determined.

As the Portfolio Allocation Drifts, so Does the Risk



Source: ACG Research, Bloomberg Barclays, MSCI

Rebalancing in a Time of Volatility

If there's one thing that investors learn over time it's that short-term movements are exceedingly difficult to predict. Over the long run, we believe that investors are rewarded for including various types of risk assets in a portfolio. In the short run, however, there are frequently qualitative and quantitative factors that come into play, overwhelming what fundamental valuations might otherwise suggest. Fear, momentum and governmental policy can all influence near-term returns, raising questions as to whether a portfolio built for the long run is also the best in the short run. With that backdrop, there may be advantages to letting a portfolio drift, rather than focusing on rebalancing to target. Scenario analysis shows us that letting the portfolio drift without rebalancing in a period of trending markets improves the return. Conversely, in times of volatile or choppy markets, rebalancing tends to be more favorable.

Rebalancing Impact Depends on Path of Returns

Type of Market	Systematic Rebalancing	Drifting Portfolio	Rebalance Advantage
Trending Up	11.0%	11.5%	-0.5%
Trending Down	-1.0%	-0.4%	-0.6%
Choppy Up	5.0%	4.5%	0.5%
Choppy Down	-2.5%	-2.8%	0.3%

*Based on hypothetical portfolio scenarios for illustrative purposes. Rebalancing (if done) takes the portfolios fully back to target at the end of each period.

Source: ACG Research

Best Practices

As noted earlier, there is no single optimal strategy for investors. Risk appetite, governance, and potential cost incurred all play a role. Looking at the portfolio's actual allocation on a daily or weekly basis carries administrative burdens, while reviewing only once a year may rely too heavily on one point in time. Costs are incurred when trades are made, but for taxpayers, there will likely be recognized gains or losses to also consider. The value of rebalancing must be viewed through these varied lenses.

ACG's Position

There's an opportunity for learning during a crisis, rather than simply addressing the challenges that come with increased volatility. ACG favors a disciplined rebalancing process, focusing on risk management and administrative burden, with tax consequences and transaction costs playing a lesser, but still important role. Creating bands that allow for some drift while keeping risk contained is an important part of the process. Asset owners should use this time to reassess their allocations, risk tolerance bands and process for reviewing the current levels in asset classes to ensure their goals are being met. A policy that includes monthly oversight with rebalancing only when moderate ranges around targets are reached is a good place to start.

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