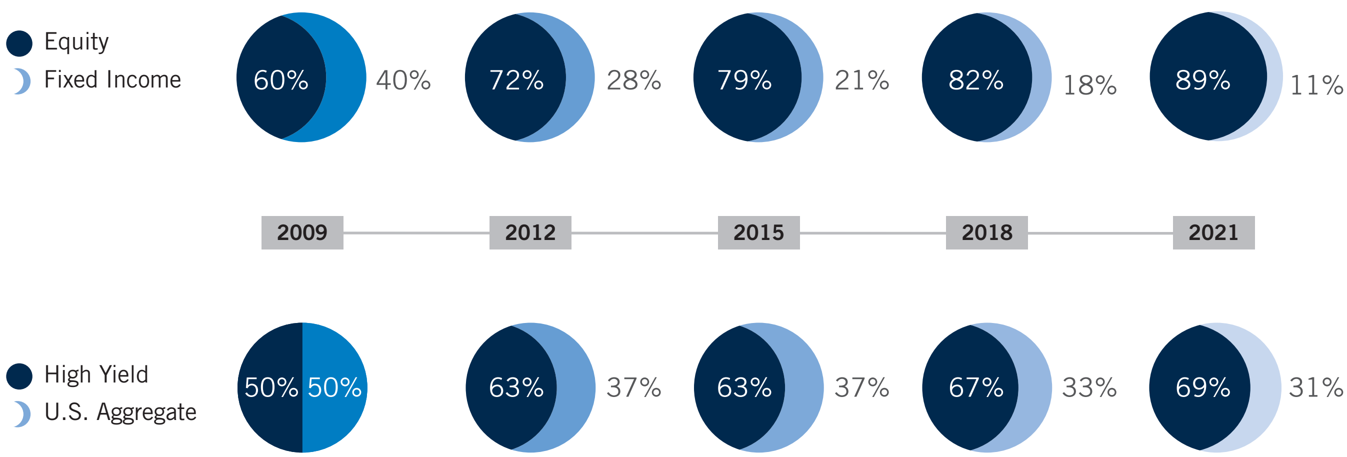
Rebalancing Revisited: Are Your Allocations Out of Whack?

Whatever their desired asset allocations, now may be a good time for investors, particularly those in or nearing retirement, to consider rebalancing portfolios to mitigate drawdown risk.

As investors review their portfolios in the face of volatility and uncertainty, they may find their overall portfolios very imbalanced. After all, assets grow at different rates, and investors in U.S. assets have done spectacularly well in the last decade, and 2021 was a banner year that may be difficult to match. All of which underscores the case for investors, especially retirees, to rebalance their portfolios and diversify into assets with the potential for lower volatility.

EXHIBIT 1: IMBALANCED PORTFOLIOS

Strong market performance drove many portfolios out of balance between 2009 and 2021



Past performance is not indicative of future results. Portfolios shown as of 3/2/09, 12/31/12, 12/31/15, 12/31/18, and 12/31/21. Fixed Income and U.S. Aggregate are represented by the **Bloomberg U.S. Aggregate Index.** Equity is represented by the **S&P 500® Index**. High yield is represented by the **Bloomberg U.S. Corporate High Yield Bond Index.** Indexes are defined on page 4. Source: Ned Davis Research. © 2022 Ned Davis Research, Inc. See full disclosure on page 4.

Rebalancing Basics

There are basically three different ways to rebalance portfolios:

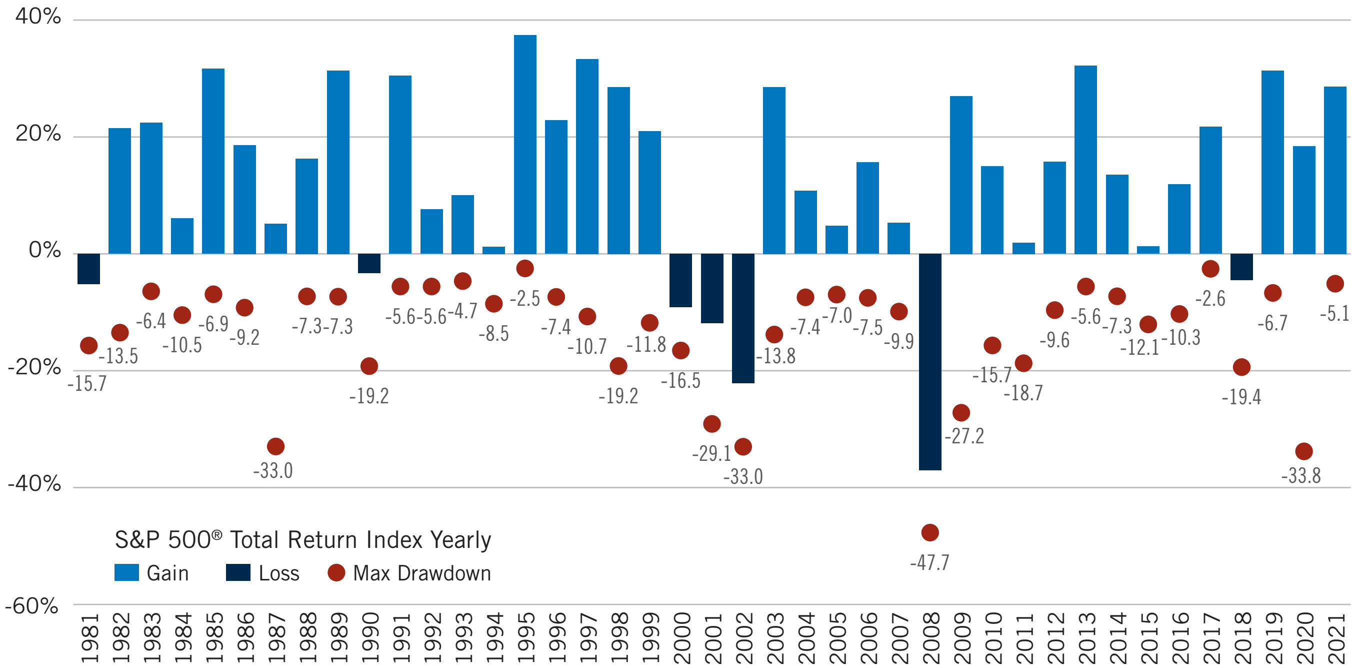
1. Sell investments from overweighted asset categories and use the proceeds to purchase investments in underweighted asset categories.
2. Purchase new investments in underweighted asset categories.
3. If you make continuous contributions to the portfolio, you can alter your contributions so that more investments go to underweighted asset categories until your portfolio is back into balance.[1]

[1] "Guide to Asset Allocation, Diversification, and Rebalancing," Securities and Exchange Commission, sec.gov

Many financial advisors recommend rebalancing at least once a year. Others suggest basing such decisions on how far allocations have drifted from a target allocation. (One variation of that is rebalancing according to each asset's expected volatility; a more volatile asset, for instance, might have a wider rebalancing threshold.) Any of these approaches should help avoid trading based on emotion, a behavior that can be magnified in the types of substantial market declines shown in Exhibit 2. As a general rule, the more concentrated the position, the more reason to create guidelines on when to rebalance. Some investors may incorporate momentum into their rebalancing guidelines to hold on to highly innovative companies that are growing much faster than their respective industries or respective benchmarks.

EXHIBIT 2: CALENDAR YEAR MARKET RETURNS AND PULLBACKS ARE UNPREDICTABLE

Often up, sometimes down, we almost never experience an "average" year.



Past performance is not indicative of future results. Source: Ned Davis Research. © 2022 Ned Davis Research, Inc. See full disclosure on page 4. The **S&P 500® Index** and **Maximum Pullback** are defined on page 4.

Mitigating Risk

The goal of rebalancing is to mitigate the risk of significant losses by keeping your portfolio well diversified.

Can rebalancing actually improve returns? Maybe.

Some academic studies have concluded that sometimes rebalancing outperformed drifting portfolios over the years, albeit with greater risk, and sometimes they didn't. Some market professionals contend that returns between asset classes need to be uncorrelated and fall within a narrow band in order for rebalanced portfolios to outperform.[2]

Timing the market or, for that matter, just selling winning stocks and moving into bonds may actually reduce long-term returns, especially if those winners are part of a secular bull market. Take real estate investment trusts (REITs), for instance, which many investors have kept as core holdings for the long term. REITs have historically outperformed broad equities and fixed income over the long term, according to the National Association of Real Estate Trusts.

That being said, the case *for* rebalancing includes the potential to improve *risk-adjusted* returns over time, especially if different categories of stocks with more attractive valuations and similar return characteristics are selected.

Case in point: March 2020, when the U.S. and international markets plunged at the start of the COVID-19 pandemic. Moving back into stocks after such a sharp drop gave investors an opportunity to buy at a discount and improve the potential for higher risk-adjusted returns in the long run, as evidenced by sharp gains in 2021.

Avoiding Mistakes

While rebalancing is one way to attempt to maximize gains in a portfolio and can be especially beneficial before a correction, some investors may find the mechanics off-putting.

In rebalancing, some investors may forget to include IRAs and/or 401(k)s. They may underestimate the impact of taxes on capital gains and dividends—and commissions. Or, they may put too much in bonds and cash because they fear short-term risk and volatility. In any case, the importance of consulting a financial advisor cannot be emphasized enough. Remember: Stocks historically have outperformed other assets, and excessive timidity (or complacency) in asset allocation can undermine an investor's chances of reaching their goals after inflation.

A Smoother Ride

By rebalancing, you'll ensure that a portfolio does not overemphasize one or more asset categories, and may return it to a more appropriate level of risk.

Of course, no one asset allocation is proper for everyone. The asset-allocation plan for each individual will most likely differ according to age, income, financial goals, risk tolerance, and other factors. And, as industry regulator FINRA warns, rebalancing may incur sales charges and other fees and switching out of investments when the market is doing poorly means locking in a loss. Selling appreciated assets to rebalance a portfolio in a taxable brokerage account could result in capital gains taxes, FINRA adds.

[2] Anthony Xie, "Does Portfolio Rebalancing Actually Improve Returns," HodlBlog, May 28, 2018.

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The **S&P 500® Index** is a free-float market-capitalization weighted index of 500 of the largest U.S. companies. The index is calculated on a total return basis with dividends reinvested. The **MSCI AC World Index (net)** is a free float-adjusted market capitalization-weighted index that measures equity performance of developed and emerging markets. The index is calculated on a total return basis with net dividends reinvested. The **Bloomberg U.S. Aggregate Bond Index** measures the U.S. investment grade fixed rate bond market. The index is calculated on a total return basis. The **Bloomberg U.S. Corporate High Yield Bond Index** measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded. The index is calculated on a total return basis.

The indexes are unmanaged, their returns do not reflect any fees, expenses, or sales charges, and they are not available for direct investment.

A **pullback (or drawdown)** is usually quoted as the percentage between the peak and the trough prices during a specific record period of an investment, fund, or commodity.

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