EUREKA report

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Rebalance, and realign your portfolio

By Doug Turek

PORTFOLIO POINT: Left unattended, portfolios can stray out of sync with your intentions, becoming riskier or denting your returns.

"Rebalancing" – it sounds like something to do with maintaining your car's tyres, but in fact it's a strategy designed to control investment risk and potentially enhance returns. It's an important part of maintaining your investment portfolio, and that's something you should do regularly.

The tax year end is a good trigger event for investors to undertake a minimum once a year portfolio rebalance. A lot happens at this time of year including:

- Pre and post-June 30 asset sales may be undertaken to capture losses and postpone tax on gains.
- Pensions are drawn, some doing so at the latest they can in the tax year, while others take out funds in early July for the period ahead.
- Funds distribute accumulated dividends, rent, interest and realised capital.
- Year-end superannuation contributions are made, which could vary from a small eligible co-contribution to big personal deductible and non-concessional contributions.
- Tax bills on large taxable investment portfolios may also have just been paid a month or so before

These various cash flows, coupled with changes in valuations of your various holdings, create an opportunity – in many cases an imperative – to realign your investments.

Rebalancing controls risk as it brings your portfolio back in line with the level of risk you deemed appropriate when you set it up. If you don't regularly rebalance your portfolio, it can become "riskier" over time and more volatile: you can even put at risk the ability of your nest egg to pay long-term retirement income depending on the size of your pension drawings.

Imagine a portfolio invested 60% in Australian equities and 40% in short-term bonds at October 2002. If left alone unbalanced with dividends and interest separately reinvested, then five years later, in October 2007, this portfolio would have drifted to a 76% equities, 24% bond allocation. It would have been much more exposed to the downturn in the market that began the following month.

Many investors, as they get older and wealthier, are less willing or able to take on financial risk and their allocation often needs to be more conservative. It is important to realise that although a high or all-equity portfolio offers a higher average return when funding a stream of retirement pension payments, the probability of funds running out early can be higher than if a more balanced portfolio is used. High growth portfolios don't weather the equivalent of a 100-year flood that the investment markets seem to have about every 10 years!

Not all portfolios become riskier over time. Those awash in yield can become too conservative or too "lazy" if not rebalanced. There the risk may be not achieving goals for the growth of the portfolio.

Returns may increase following disciplined rebalancing because some asset classes have a tendency to get ahead of themselves in terms of price; effectively rebalancing favours a "buy low, sell high" discipline.

This can be demonstrated by analysing the returns of an Australian balanced portfolio with target exposures of 33% Australian equities (represented by the ASX 200 Accumulation index), 20% international equities (unhedged MSCI ex-Australia), 15% listed property (ASX 300 property trust accumulation index) and 32% bonds (UBS Warburg composite bond index) over the 20 year period from May 1988 to 30 April 2008. The returns and standard deviation (the latter a measure of the "bumpiness" or volatility of returns and something particularly important to minimise when pension funding) are as follows:

- 10.02% pa return, 7.33% pa standard deviation if annually rebalanced.
- 9.77% pa return, 8.05% pa standard deviation if not rebalanced.

During his recent visit to Australia Burton Malkiel, the author of *A Random Walk Down Wall Street*, (see ***Why it's so hard to 'beat the street'***) offered a similar comparison for a 60/40 equity/bond portfolio constructed from US stocks and bonds made up of the Russell 3000 equity index and Lehman Brothers bond index over the 10 years from January 1996 to December 2005.

- 8.46% pa return, 9.28% standard deviation if annually rebalanced.
- 8.08% pa return, 10.05% standard deviation if not rebalanced.

In both our local and the US comparison, rebalanced portfolios outperformed in terms of return and risk over the period.

While risk is managed, returns are not always enhanced by rebalancing. In a long steady bull market, allowing your portfolio to drift up in overall equity exposure would have generated a larger return than periodically taking small amounts of equity risk "off the table". Rebalancing works best during periods of volatility and between growth assets whose prices behave somewhat differently (ie, correlate poorly).

Rebalancing can be done on a periodic basis, for instance annually or twice-annually, or when your portfolio moves out of "control limits" or tolerances you set. In the latter case, relatively wide tolerances are necessary to avoid excess trading during periods of substantial market volatility, and to limit transaction costs and possible taxes.

If you are contributing or withdrawing money for other purposes, rebalancing can be incorporated with no additional cost. You simply sell a little bit more or a little bit less of your assets to keep them in balance. If you are regularly adding to your portfolio, then you could use new cash to invest in a proportional fashion at each investment or just periodically.

In a professionally managed portfolio, an adviser might align portfolio rebalancing with a twice annual strategy reviews. In this way we can link changes in personal circumstances with portfolio changes where necessary. I use tolerances of +/– 10% of the target percentage allocation to guide making rebalancing decisions.

This is because we need to be careful to avoid transaction costs, including tax for some, if other selling or investing isn't been done. In those circumstance if for instance a client's overall target exposure to Australian small companies is 10% and their current allocation is 9.5% then we might not adjust that. But if it is 8.5% we might aim to buy 1.5% more. If we were investing new money then we would allocate a little more of this to that asset class to raise its proportion. For every underweight position, there must be some overweight position, so we would buy less of or sell more

A sample of previous year's rebalancing activities showed that in many cases we sold small amounts of listed property, often topping up mainly short-term bond allocations. At present we are buying back some of that and other equities and lightening up on overweight cash, bonds and emerging markets.

Of course, rebalancing only works if you have a target allocation of assets, which unfortunately not many have. Your allocation shouldn't change frequently if you are a strategic investor. If you have a bias towards "tactical asset allocation" (backing your conviction about changes in market prices through trading) then you need to overlay your view of the future and adjust allocations accordingly.

Rebalancing raises other portfolio management considerations:

- Having "liquidity" in your portfolio makes it easier to rebalance and perhaps take advantage

of opportunities. A 100% equity portfolio with dividend reinvestment plans in place is a "dry portfolio". Those investors who have (or had!) a very high allocation in equities would have found themselves without the resources to buy into lower valuations during the gloom in February and March.

- Ticking the box to have your shares or managed funds reinvest dividends and distributions may rob you of the cash flow necessary to strategically rebalance your funds. It may also create a headache for your accountant tasked with working out your cost base. Keep in mind that some dividend reinvestment plans offer a small discount, which may give a compensating benefit for your increased accounting expenses. Of course, leaving distributions in cash for too long could slow growth of your portfolio.

- Separating your equity and "bond" exposures, for instance, between an online trading account and a high-yielding bank savings account requires you to periodically move money between the accounts. If the two accounts don't or infrequently "talk to each other" there is a danger you are compartmentalising and not properly rebalancing your overall wealth position.

- Rebalancing can apply at the individual stock level. Within an equity portfolio, it is not uncommon to find one or two high-performing stocks that over time become a substantial proportion of assets. While we like to "buy and hold" we should be careful to trust too much of our financial prosperity to any one single company. I have met many people for whom BHP represents more than 30% of their wealth and indeed quality of retirement. When it is that high, the question of whether BHP has favourable short-term prospects isn't really relevant. If BHP and Rio Tinto merge, I imagine this will be a bigger problem for many. It's also an issue now in listed property where Westfield and Stockland now account for about 50% of the Australian property trust market.

- Rebalancing might also be looked at from a sector perspective. After such a run up in valuations, one might have trimmed back on listed property and bank shares to benefit now to buy them back at lower valuations. A disciplined rebalancing philosophy might see you take some profits from resources and plough them back perhaps into bank shares, if not cash. When it comes to investing in the China story, remember the four most expensive words in finance are "this time it's different".

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