

# Revisiting the role of rebalancing: answers for today's tough issues

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***The sharp decline in equities over the past year has left most investors scared, perhaps terrified, about losing more money in the financial markets. Some investors are wondering if they should decrease their portfolio risk. Others, who are staying invested, have seen their current allocations deviate significantly from the original target allocation. And these investors are asking whether or not they should rebalance their portfolios back to its target in such a volatile market. This paper provides Russell's viewpoint and guidance on what investors can do in these situations.***

## **Should investors decrease their risk by reallocating their portfolio?**

Advisors are asking if they should take a tactical position with clients' portfolios to try to reduce volatility and minimise risk. Sometimes confused with rebalancing, this is actually tactical asset allocation. And the textbook answer to this question from an investment perspective is "no". Anxiety over market volatility is not a reason to tactically reposition a portfolio if a client's long-term investment objectives have not changed and if the client has five years or more before retirement.

On the other hand, if the client is a retiree or is very near to retirement and events in financial markets have materially changed their circumstances, then it is a matter of strategic reallocation, not a tactical reallocation or rebalancing exercise.

## **What about investors who want to go to cash no matter what?**

We understand you may have a few clients who are so anxious about the markets that they simply will not stay invested. For these clients, the goal is to do just enough to address their need to do something and nothing more. For some that may simply mean reallocating or reducing their equity exposure from 60% to 40% for now and investing the difference in a conservative allocation of fixed income instruments. When suggesting this move to a client, please ensure that it is the smallest change they will accept in response to the problem. Also, it's important to get them to agree on a firm schedule to move back into their original equity allocation, probably by cost averaging over an agreed upon timeline such as a year.

## **Should investors who are remaining invested rebalance back to their target allocation?**

Russell believes rebalancing is a vital part of portfolio management. Its purpose is to ensure that the portfolio maintains its long-term asset allocation by periodically eliminating deviations in the portfolio from the target allocation, which are caused by the natural movements of the market. The motivation behind this is that significant deviations from the original allocation represent additional, and in most cases avoidable,

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unrewarded risk. Rebalancing helps investors stay the course, not shift away from it. It's a mechanical discipline to override the negative impact of our behavioral tendencies. This discipline is most important in periods like this.

### **How does Russell approach rebalancing?**

Typically, Russell's funds are rebalanced using cash flow to bring funds closer to their target allocation when appropriate. This means that as cash flows into (or out of) the fund of funds, it is invested first in the underlying fund/asset class that is farthest away from its target, then into the underlying fund/asset class that is next most out of balance, and so on.

Now let's consider a client's portfolio that veered off the mark due to extreme volatility. Russell recommends rebalancing client portfolios back to the threshold of the lower edges of the tolerance bands if the portfolio is outside of its original target allocation. For example, if the risk target is 60/40 plus or minus 5% and they are currently at 30/70, then go to 55/45. We recommend going to the lower bands because it allows the portfolios to deviate, within reason, from the stated target allocation but with minimal impact to the risk and return characteristics of the portfolio. The benefit of this is that it minimises unnecessary rebalancing, reducing trading costs. If you have a client that is already at the lower threshold of the bands, stay put. There is no reason to rebalance unless your client's portfolio moves outside of the tolerance band.

### **When would Russell recommend rebalancing back to the target allocation, not to the lower edges of the tolerance bands?**

At some point you'll want to take your clients back to the target allocation. We suggest that you do this when you feel that market volatility has mitigated enough that going back to target will not require a lot of unnecessary trades in order to remain at target.

### **The Final Word: Staying the Course**

We agree that this is an unprecedented bear market, but bear markets are a fact of investing. When investment prices decrease significantly, human instincts say unload what you have and avoid buying new ones. Your clients are afraid investments will go down even more, we understand that. But remind them that although past performance is not indicative of future results, historically each bear market has been followed by the next bull market, and that a bull market usually starts well before the news is good. So if history is any guide, your clients are better off staying the course rather than changing their long-term strategy to try to avoid short-term risk.

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