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Reallocation Versus Rebalancing

by W. Scott Simon | 03-05-09

The allocation of many portfolios has changed as a result of significant movements in financial markets, especially over the last six months. Given this broad disarray in financial markets, advisors might find a brief discussion about the difference between (1) rebalancing a portfolio's current asset allocation and (2) outright changing a portfolio's target asset allocation to be of interest.

Asset Allocation

"Asset allocation" is the way in which investable money is distributed among the asset classes in a portfolio. Commentary to the Restatement (Third) of Trusts (Prudent Investor Rule) explains: "Asset allocation decisions . deal with the categories of investments to be included in a trust portfolio and the portions of the trust estate to be allocated to each. These decisions are subject to adjustment from time to time as changes occur in economic conditions or expectations or in the needs or investment objectives of the trust." (Section 227, comment g, pages 25-26.) William F. Sharpe, a 1990 Nobel laureate, observes: "It is generally agreed by theoreticians and practitioners alike that the asset allocation decision is by far the most important made by the investor."

Rebalancing a Portfolio's Current Asset Allocation

Rebalancing is a systematic, unemotional way to purchase more securities to add to a portfolio and sell existing securities from it in order to move the portfolio's current asset allocation toward its target asset allocation. Suppose, for example, that the stock market takes a tumble and as a result a portfolio's current allocation is 60% stocks and 40% fixed-income investments, but that the portfolio's target allocation is 70% stocks and 30% fixed-income investments. An investor would need to buy more stocks and sell some bonds in order to rebalance the portfolio.

It's obvious that normal (or abnormal) movements in financial markets will cause a portfolio's resultant asset allocation to deviate from its target allocation from time to time. The continuous rebalancing of a portfolio back toward its target allocation, however, can generate significant costs (and taxes for taxable investors) that, of course, have a negative impact on bottom line portfolio performance.

That's why it makes sense ordinarily to establish a minimum and maximum range by which a portfolio's current allocation may deviate from its target allocation. For example, suppose that a portfolio's target allocation is 70% stocks and 30% fixed income investments and the range by which the portfolio's current allocation may deviate from its target allocation is ten percentage points. This means that the portfolio's current allocation could range from a minimum of 60% to a maximum of 80% for stocks and from a minimum of 20% to a maximum of 40% for fixed income investments. The use of such a range helps limit the impact of any costs on portfolio return that could otherwise be generated as a result of unnecessary portfolio rebalancing.

In a portfolio that's diversified broadly, it takes significant shifts in financial markets for the portfolio's current allocation to deviate from its target allocation more than the permitted range. That's why an investor shouldn't need to rebalance its portfolios too often. The recent significant turmoil in financial markets, however, has required even broadly diversified portfolios to be rebalanced.

When an investor does rebalance, though, it shouldn't do so for the purpose of attempting to boost the return (or limit the loss) of a portfolio. Such attempts often involve efforts at market timing, stock picking, and track-record investing, which a mountain of academic studies shows is a loser's game. Any rebalancing should instead be undertaken to maintain the portfolio's risk level while taking into consideration the impact that bid-ask spread costs, market impact costs, trading costs and any other costs (and taxes) can have on a portfolio's performance when rebalancing the portfolio back toward its target allocation.

By the way, it should be acknowledged that it can be psychologically difficult for some investors to purchase out-of-favor asset classes (such as stocks in a falling stock market) that have performed poorly and sell asset classes (such as fixed-income investments in a falling stock market) that have performed relatively better.

Changing a Portfolio's Target Asset Allocation

Changing a portfolio's target asset allocation, in sharp contrast, outright alters its target allocation; this act actually changes the investment policy of the portfolio. Consider the same previous example in which the stock market falls and a portfolio's current allocation goes to 60% stocks and 40% fixed-income investments, but the portfolio's target allocation is 70% stocks and 30% fixed-income investments. An investor in this case might not wish to move back toward the target allocation of 70/30, but instead establish an entirely new target allocation of 60% stocks and 40% fixed-income investments. The investor would not need to buy more stocks or sell any bonds because the portfolio's new target allocation is now the same as its current allocation.

Why would an investor change a portfolio's target asset allocation? In a family trust, a target allocation may be altered as a result of changes in "the purposes, terms, distribution requirements, and other circumstances of the trust." [See section 2(a) of the Uniform Prudent Investor Act and California probate code section 16047(a).] A change in the personal circumstances of a trust's beneficiaries such as purchasing a home or sending children to college could cause the trustee of the trust to alter a portfolio's target allocation from, say, 70/30 to 50/50.

In a charitable trust, a target allocation may be changed as a result of changes in the spending needs of a trust beneficiary. For example, if the scope of a beneficiary's mission is widened significantly, a larger distribution from the trust may be necessary. This may require an increase in fixed-income investments in order to generate more current income. That in turn would result in a change to the target allocation of the portfolio (i.e., a greater percentage of fixed income investments) which alters the portfolio's investment policy.

Requests to change target allocations often result from an investor substituting its own personal subjective risk tolerance for the risk tolerance of the portfolio. This can occur, for example, when a trustee reacts personally to occurrences in financial markets, thereby causing it to demand that a portfolio's target allocation be changed because of concerns about liability for the poor investment performance of a trust portfolio.

Ordinarily, however, once a portfolio's target asset allocation is set, it shouldn't be changed--even during periods of significant volatility in financial markets. This belief is supported by the notion that the broad risk and return relationships among asset classes remain intact long term. Indeed, all investing would be chaos if these relationships didn't hold up over the long run. That's why portfolios should be composed of prudent, broadly diversified, low-cost institutional-level asset-class mutual funds and index mutual funds that have demonstrated dissimilar price movements historically.

Theoretical and empirical research, as well as long-term data from financial markets, confirms that risk is minimized significantly and performance can be enhanced when a portfolio holds, for long periods of time, different asset classes with dissimilar price movements. This approach, which fulfills the fundamental underlying objective of modern portfolio theory, is also in accord with the standards of modern prudent fiduciary investing.

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Simon provides services as a consultant and expert witness on fiduciary issues in litigation and arbitrations. He is a member of the State Bar of California, a Certified Financial Planner, and an Accredited Investment Fiduciary Analyst. Simon's certification as an AIFA qualifies him to conduct

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