Rebalancing Portfolios in Volatile Markets

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Maintaining a disciplined approach to rebalancing portfolios remains an important pillar of a comprehensive plan for achieving investment goals. The market volatility in the first quarter of 2020 has served as an important reminder of this. Investors who had been paring back equities as the market reached new highs fared better during the pullback than if they had just let the winners run. Those who rebalanced back into equities after the market's precipitous drop may have also benefited as the market has rebounded.

Rebalancing approaches

In a previous paper[1] we discussed some of the different considerations related to rebalancing. Any disciplined and systematic rebalancing approach is likely to yield benefits for investors, so having one in place could probably be more important than the specific parameters of how it is implemented. The lack of a systematic approach can lead to poor decisions, as our behavioral biases as humans take over, especially in times of crisis. Key decisions to consider when designing a rebalancing policy include:

- Whether to rebalance on a calendar-based schedule or in response to allocation drift
  - If rebalancing based on drift, the size of allowable drift bands around targets
- The frequency of monitoring portfolios for drift
- How far back to rebalance portfolios

While the economic outlook remains highly uncertain and we are likely to see further market volatility in the coming months, we thought it would be helpful to review some of these considerations and look at their impact on portfolios over recent months.

Drift vs. calendar

We've long argued that drift-based rebalancing is superior to calendar-based. Rebalancing as needed, rather than according to a fixed schedule, makes intuitive sense. The primary benefit of calendar-based rebalancing is the ease of implementation, as it avoids the need to continually monitor portfolios for drift. It can, however, result in missed opportunities to sell near market peaks and buy at lows. Consider an approach that rebalances portfolios at the start of every year. Such an approach may have pared back some equity exposure in January, but would not have re-allocated into equities when the market hit its common lows in March. In contrast, for the accounts we manage that employ drift-based approaches, the vast majority rebalanced out of fixed income and into equities in March as the market was near its lows. As of mid-May, some of those accounts are now nearing levels where we would rebalance back into fixed income.

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With drift-based rebalancing, the frequency of monitoring portfolios can also be important. More frequent monitoring is generally preferable. Studies[2] have shown that monitoring portfolios for drift on a daily basis yielded better results than monthly, quarterly or semiannual monitoring. The benefit increased monotonically as the timeframe shortened. The recent market downturn provided additional anecdotal evidence to support this view. The majority of accounts that were rebalanced hit rebalancing thresholds in mid-March. Waiting until month or quarter end would have resulted in rebalancing after the market rebounded somewhat from its lows, diluting the benefit.

The best research we've found on deciding how far back to rebalance portfolios was by Seth Masters. His paper[3] makes the case for rebalancing halfway back to target as a way to optimize the benefits of rebalancing (a quadratic function) against the costs (a linear function). In practice, however, this theory may not always play out. The rapid rebound we saw in the market since the mid-March lows has benefited accounts that rebalanced more aggressively back into equities (i.e. more than 50% of the way back towards the target weight).

Trading and liquidity

Many accounts triggered rebalancing thresholds shortly after the precipitous fall in the equity markets. Liquidity, especially in certain segments of the fixed income markets such as municipal bonds and credit, was unusually low. This required a thoughtful approach to rebalancing. Trying to force through fixed income trades was at worst impossible and at best likely to result in very poor execution. As a result, rebalancing that normally can be completed in a day stretched out over a week or longer in some cases, as fixed income strategies raised cash only as liquidity permitted. As cash became available, it was invested into equities.

Implementing a rebalancing approach

Monitoring portfolios for drift on a frequent basis and acting quickly but thoughtfully when rebalancing is necessary has the potential to generate meaningful benefits for clients. Executing such an approach is not easy, but using a unified managed account (UMA) can help. In a UMA, all assets are housed in a single custodial account. This facilitates rebalancing by allowing an overlay manager to do the necessary buying and selling simultaneously, and avoiding the need to shift money between accounts, which can cause extensive delays and incur more frictional costs. Many overlay managers also have systems in place to monitor portfolios on a daily basis for drift and act immediately when the need to rebalance arises.

1 "Rebalancing Multi-Asset Portfolios: Implementation Considerations." Natixis Investment Managers whitepaper, 2013.

2 Buetow, Gerald, Ronlad Sellers, Donald Trotter, Elaine Hunt and Willie Whipple. "The Benefits of Rebalancing." *The Journal of Portfolio Management,* Winter 2002.

3 Masters, Seth. "Rebalancing." *The Journal of Portfolio Management,* Spring 2003.

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