In Defense of Rebalancing

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Turning the calendar from one month to the next should not have any bearing on equity market performance. In reality, however, it seems that market sentiment does actually change once we move into a new month, quarter, etc. There was no place to hide in July and August as equities and high yield bonds sold off across all market capitalizations and geographies.

Index	August/Sept	October
S&P 500	-8.4%	8.4%
MSCI All-Country World	-10.1%	7.9%
MSCI Emerging Market	-11.7%	7.1%
Barclays High Yield Bond	-4.3%	2.8%

The market rally that began as the calendar turned to October was the best month for US equities in four years. Once the month was in the books, there were some interesting statistics regarding ETF flows. First, US equity ETFs took in $10 billion, almost double the YTD inflows of $6 billion through September. Second, US corporate bond ETFs saw $8.3 billion in inflows—an all-time record. Most of these flows went into high-yield bonds. Emerging markets saw small net inflows of $1.6 billion, a healthy reversal from $7.2 billion in outflows over the prior 12 months. Finally, health care was the leading sector in terms of outflows. $1.2 billion left healthcare ETFs after $9.1 billion in inflows over the prior 9 months.

It is tempting to look at these fund flow statistics through the negative lens of short-term trading or even performance chasing. While these trends could be the motivation behind the shift in sentiment, it is possible that a different and decidedly old-fashioned force could have been at work: Rebalancing. Periodic portfolio rebalancing is one of the most effective risk-management tools that investors can utilize, yet it can also be one of the hardest to carry out. Why? While the math tells us re-balancing leads to better risk-adjusted long-term returns, our human instinct is to chase the asset classes that have been "working". Behavioral economists refer to this action as "inappropriate extrapolation" or "recency bias", the assumption that what has just occurred will continue to occur into the future. It is emotionally hard to sell an asset that has outperformed in order to buy an asset that has underperformed. Yet this is exactly what investors should do to improve long-term, risk-adjusted returns.

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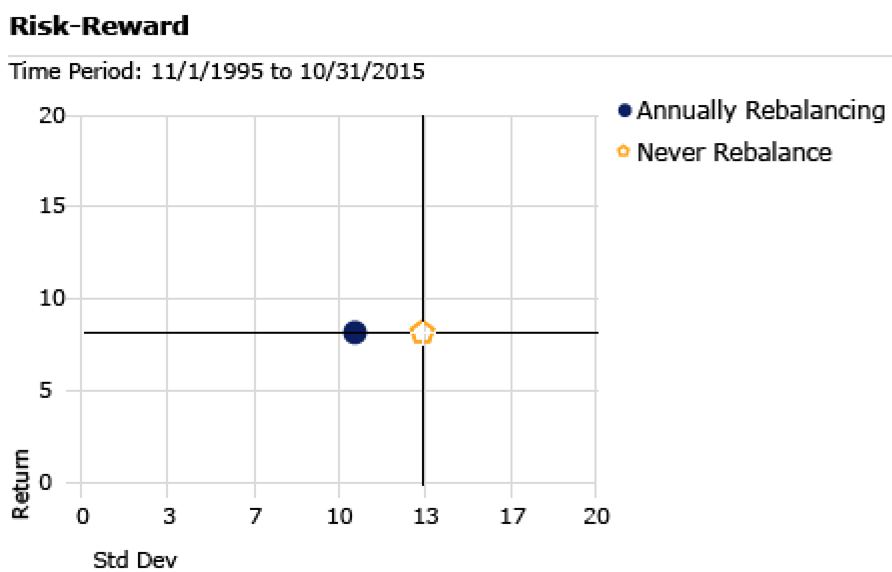
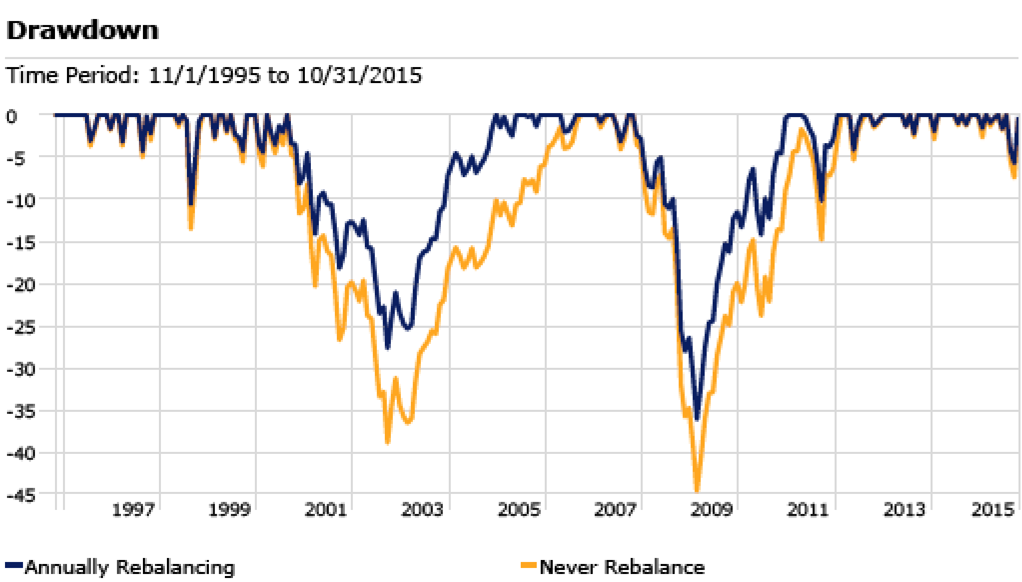
Re-balancing might be the closest thing one can get to a "free lunch" in investing. Looking back over the last 20 years, a period which saw two bear markets, a portfolio that was re-balanced on an annual basis matched the return of an unbalanced portfolio while experiencing 20% less volatility and 24% less downside capture.





Source: Morningstar

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Downside risk matters for two very important reasons. First, it is easier to compound money over time when you don't have large drawdowns. Second, when drawdowns do occur, the natural tendency is to sell equities and hold cash in the hope of preventing future losses. Because it is impossible to know when markets will reverse, this action is not part of a repeatable investment process. In reality, during market drawdowns investors should sell their outperforming bonds to buy underperforming equities.

Due to the relative underperformance of equities through 9/30, a portfolio that began the year invested 70% in the S&P 500 and 30% in the Barclays Aggregate Bond Index became 68% S&P 500, 32% Barclays Aggregate on 9/30. This created a great opportunity for short-term re-balancing which paid off handsomely in October. As the long-term data suggests, applying the rebalancing process repeatedly rewards investors even when it doesn't "feel right" to sell what has "worked".