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Why You Should Rebalance (And Why You Shouldn't)

By Nathan Hale | May 21, 2011 | 2 Comments

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Proponents of active management are ever-searching for a way to discount indexing's strong long-term record against actively managed funds. The arguments used to be about how to index was to accept mediocrity. Or that indexing only worked in bull markets, and actively managed funds would thrive in comparison during flat or bear markets. Or that index funds were capital gain powder kegs that would level their investors with taxable distributions when their owners fled during a bear market.

One by one, arguments like those have been disproven over the years, as index funds — and, for the large part, their investors — have proven their mettle through all sorts of market conditions.

But recently I've read another curious claim by active management defenders. Actually, it's not so much a defense of active management, but an attempt to knock some of the self-satisfaction out of the index fund investor.

The claim is that most index fund investors rebalance their accounts — bringing their stock/bond allocation back into alignment with their risk tolerance — and that rebalancing is somehow regarded as a tool of active managers, and therefore these index fund investors are actually engaged in active management.

To that I say: What?

The disconnect, I think, lies in a misunderstanding of the role of rebalancing. Active fund managers will buy and sell stocks based upon their outlook for the market — loading up on cash when they think markets are going to fall, and reversing course when they think a bull market is in the offing.

That's market timing; rebalancing has nothing to do with market timing. Properly done, an investor who rebalances his 55 percent / 45 percent stock / bond portfolio back to its original 50/50 mix isn't betting that the stock market is set to tumble. Rather, they're engaged in risk control, which is what any prudent investor — active, index, or otherwise — should be doing.

Fifteen years ago investment advisor **Bill Bernstein** published a study which showed that periodic rebalancing provided a performance bonus. A policy of selling what's been hot and purchasing what's lagged, it turned out, produced superior returns than simply letting everything run its course.

That's wonderful, and it makes a certain amount of intuitive sense. And, given Dr. Bernstein's reputation and his following, he no doubt converted more than a few readers.

But whether such a bonus persists in the future or not, all investors should rebalance their accounts once they get out of whack. If you've done your homework and decided that a 50/50 stock/bond mix is appropriate for your risk tolerance and time horizon, you're at risk of taking too much (or too little) risk if you simply let your allocation drift in the market's winds.

A friend of mine used to argue against rebalancing, pulling out a chart depicting the long-term returns of stock and bonds. "Look," he'd say, "If I never rebalanced over 60 years, my investment would be worth $500,000, while your 50/50 rebalanced account would only be worth $300,000."

I'd acknowledge that was true, but would point out to him that his original 50/50 asset mix had morphed into a 90/10 mix by the end of the period.

I never did understand why he was so surprised that a stock-heavy portfolio strongly outperformed a balanced portfolio, given that stocks had outperformed bonds by some two percentage points over that long period of time, but that fact that it did says nothing about the wisdom of rebalancing.

For if, in the example above, the stock market had plunged in year 61, the hit that the rebalanced investor took would have been a mere fraction of that suffered by the "let it ride" investor.

And that is precisely why all investors should periodically rebalance their accounts — to ensure that your portfolio is never taking on more or less risk than you've determined that is necessary to reach your goals.

Of course, the big question regarding rebalancing is how often you should do it. Many experts, including Bill Bernstein, recommend rebalancing your accounts once every two or three years. Others suggest that you do so once your allocations cross a certain threshold — say, 10 percent above or below where they should be. (Note: please don't misread that as 10 percentage points. A 10 percent threshold for a 50/50 mix would rebalance when the mix reached 55/45 or 45/55.)

Regardless of which trigger you choose to use, the important point is that you shouldn't rebalance too often. Doing so not only might result in punitive transaction costs, but might also deprive you of the short-term momentum that many asset classes exhibit.

Secondly, rebalancing requires a heavy dose of discipline. By definition, you'll be selling what everyone around you loves, and buying what they're avoiding. It sounds easy in the abstract, but selling bonds and buying stocks in the midst of the 2007 - 2008 market crisis, when the stock market's fall seemed bottomless, required an iron stomach.

And finally, investors in taxable accounts have to weigh the tax consequences of rebalancing. You obviously want to take every step possible to avoid incurring capital gains (such as redirecting contributions or distributions to the underweight asset class) but you don't want to make the mistake of letting the tax tail wag the portfolio dog — if your portfolio gets too far out of whack, you might simply have to bite the bullet and incur some taxes in order restore it to balance.

In sum, rebalancing is not an active management game. It's not even something undertaken with the expectation of increasing performance. We rebalance to control risk, plain and simple, which is what smart investing is all about.

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Nathan Hale, a pseudonym, has spent over ten years working for one of the largest firms in the financial services industry. During his career, he's researched and written extensively about personal investing, the mutual fund industry, and financial services, contributing to a number of books and articles. In this role, he uses a *nom de plume* because many of his opinions about the mutual fund industry and its practices would not endear him to its participants.

Nathan Hale

In my nearly 15 years in the financial services industry, I've had the opportunity to see the industry from perspectives that very few people are privy to. I've contributed to books, articles and academic papers that examine nearly every facet of the industry. This study has led me to develop some very strong feelings, which can be summarized with a simple general statement: Your interests and the interests of those who manage your money are often in direct conflict. Of course there are exceptions to this, but they are discouragingly rare. In light of this fact, the vast majority of my investments are held in index funds. I do own a few different actively managed funds, believing, yes, that I'm an above-average investor, and can win against all odds.

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