



## ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments



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### Longtime Vanguard Bond Manager Announces Retirement

Last week, Vanguard announced that Pamela Wisehaupt Tynan, who has managed funds for nearly three decades and worked at the fund giant for 34 years, will retire at the end of February.

She has managed the \$17.7 billion Tax-Exempt Money Market fund since 1988 and the \$12.4 billion Short-Term Tax-Exempt fund since 1996. In her role as head of Vanguard's short-term municipal bond term, Tynan oversaw all six tax-exempt money market portfolios and municipal bond fund cash reserves in addition to the funds she helmed, ultimately responsible for around \$52 billion in assets.

Justin Schwartz, who currently manages New York Tax-Exempt Money Market and Pennsylvania Tax-Exempt Money Market, will assume Tynan's role atop Tax-Exempt Money Market and Short-Term Tax-Exempt. Given that Schwartz has worked closely with Tynan since 2005, the funds' policies, strategies and objectives are unlikely to change.

### Does Portfolio Rebalancing Work?

The question of when, why and how you should rebalance your portfolio gets attention from the media on a cyclical basis, and despite all of the column inches devoted to the subject and nudges from fund companies, the conclusions are often the same—sell your winners and buy your losers at least once a year, if not once a quarter. This discussion is particularly relevant after the strong run for U.S. stocks in 2013 and 2014, which has pushed many portfolios away from their original allocations despite an up-and-down 2015 that ended the year not far from where it began.

However, looking at the data, there is reason to question if rebalancing is necessary that often, or at all, even during times of increased market volatility like we've experienced of late.

Proponents of rebalancing will tell you that the strategy is all about risk control—by sticking to a target allocation between stocks, bonds and various other asset classes, you can effectively manage the overall risk of your portfolio through various market cycles. For example, say you started with a very simple 50%–50% mix of equity and bond funds in a portfolio. After a period of stock outperformance, it could become skewed to a 60%–40% or 70%–30% mix, putting you at increased risk if stocks begin to decline. The theory behind rebalancing is to keep those allocations in check, thus reducing risk. And on the face of it, it's good (if superficial) advice.

Vanguard and Fidelity have addressed rebalancing a number of times over the years, with the firms recommending rebalancing either on a semiannual or annual basis, or when allocations drift more than 5% or 10% away from their targets.

Those conclusions seemed a bit simplistic to us, but before making any

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judgments we wanted to look at a few numbers for ourselves. We constructed a hypothetical portfolio of index funds with a 50–50% split between stocks (Vanguard 500 Index) and bonds (Vanguard Total Bond Market Index) and tracked the results of several rebalancing scenarios from January 1987 (just after Total Bond Market’s inception) through December 2015.

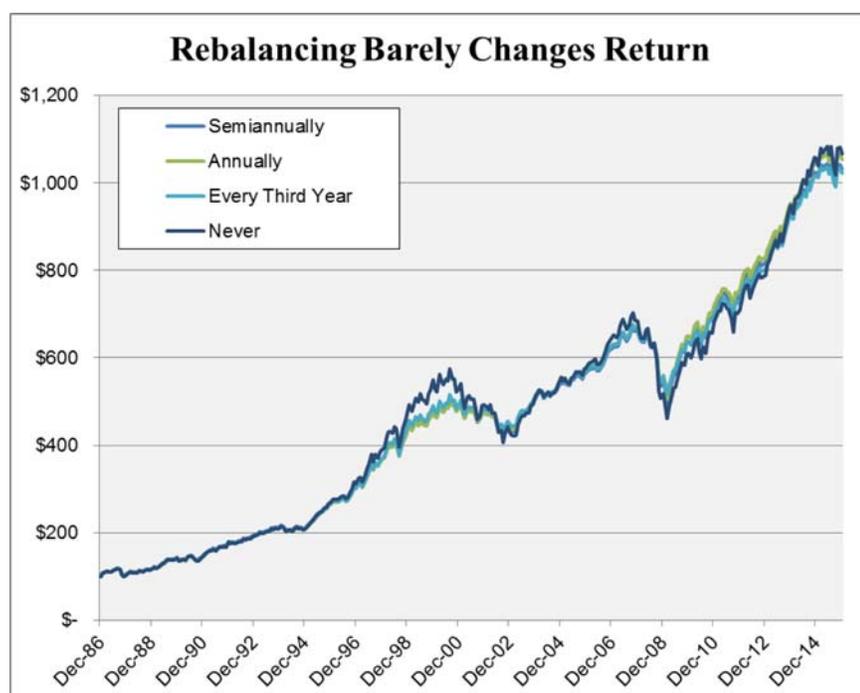
In the first scenario, we rebalanced the portfolio every six months, in January and July. In our second test, we rebalanced once a year in January, and in the third we rebalanced every third January. We also included a scenario with no rebalancing. (We picked January to rebalance because it’s best to do it after December distributions and after the tax-year has turned.)

When we looked at rolling returns for each scenario, examining average returns as well as the best and worst returns for one-month, one-year, three-year and five-year periods, our findings were pretty conclusive: The less frequently you rebalance, the greater the return potential and greater the volatility over any given period. However, when you average things out, a couple of the rebalancing schemes did result in slightly better returns over shorter periods.

It’s worth noting that no matter which period we looked at, the average returns in each scenario are all very similar, with no more than 40 basis points separating any two of them. But you can see much wider swings when comparing the best and worst periods, for example, there was a 65% swing from best to worst 12-month periods for the portfolio that was never rebalanced compared to a 51% or 52% swing for the three regularly rebalanced portfolios.

So from a volatility standpoint, rebalancing does appear to have a positive effect on a portfolio—you won’t hit the same heights, but neither will you experience the same losses an untended portfolio can suffer. A portfolio that is frequently rebalanced also stays much closer to its targeted allocation, but can still be affected by periods of high market volatility.

Through year-end 2015, the portfolio that was never rebalanced ended up with a roughly 73%–27% split between stocks and bonds, while the most frequently rebalanced portfolio—most recently in July 2015—ended up very close to its original 50%–50% allocation.



Sources: Morningstar, Adviser Investments.

As you can see in the chart above (which tracks the growth of \$100 in hypothetical portfolios split between stocks and bonds using the various rebalancing schemes), over the long haul, returns really don't suffer that much for the more frequently rebalanced portfolios even though they showed lower average returns over shorter periods. In fact the difference in the end value of the never rebalanced and the semiannually rebalanced portfolios was \$36. That's hardly an argument for never rebalancing, but it's not much of one for doing it often, either.

But what if you followed the recommendations of Fidelity and Vanguard, and instead of using time periods to determine your rebalancing strategy, you used portfolio drift? In the table below, we tested what would have happened to that 50%–50% portfolio over the same 29-year period, this time rebalancing when the spread between stocks and bonds exceeded 5% or 10%.

#### Using Portfolio Drift Has Little Impact on Performance

	# of Trades	Avg. Months Between Trades	Fewest Months Between Trades	Most Months Between Trades	Total Return	Annualized Return
<b>No Rebalancing</b>	0	—	—	—	967%	8.51%
<b>10% Spread</b>	17	20	3	75	962%	8.49%
<b>5% Spread</b>	44	8	1	49	942%	8.42%

Sources: Morningstar, Adviser Investments.

If you just look at the number of trades and the average months between, it seems like a pretty doable strategy—with a 5% spread threshold, you would have made a trade about once every eight months, and you would have traded once every year and a half or so with a 10% threshold. But that's misleading—the frequency of trades varied significantly over the 29 years, with a few periods requiring a flurry of activity after longer gaps with no trades. For example, with a 5% threshold, from January 2008 to January 2010 you would have made seven trades as stock market declines regularly pushed the balance of the portfolio towards bonds—meaning that you would have been repeatedly faced with the difficult psychological task of putting more money into stocks as their value was falling.

But even if you were that disciplined, and you had made those painful trades—what would it have gotten you? From a return standpoint, not very much. As with the time-based rebalancing schemes, there was very little difference in overall return between the portfolio that was never rebalanced and the ones that were. Former Vanguard Chairman Jack Bogle summed it up pretty well a few years back: “Rebalancing is a personal choice, not a choice that statistics can validate.”

#### Coming Up

This week, we looked strictly at returns and found neither a convincing argument for nor against frequent rebalancing, but there's more to the issue than just performance. In an upcoming *Adviser Fund Update*, we'll have more on the subject, including key concerns that anyone developing a rebalancing strategy needs to consider, so please check back in the weeks ahead.

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