ADVISER FUND UPDATE

ADVISER INVESTMENTS

Market Summary and Commentary for Individual Investors from Adviser Investments

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Rebalancing Reconsidered

In our last *Adviser Fund Update*, we put two common rebalancing strategies that Fidelity and Vanguard have recommended—time-dependent and portfolio drift—to the test. When we ran our own numbers, we found that over two-plus decades, there was little difference in return between regular, periodic rebalancing, using allocation drift greater than 5% or 10%, and never rebalancing. For the details, please take a look at our January 17, 2014 update.

Many astute readers responded, raising questions about taxes, trading fees and other potential costs involved with the rebalancing strategies we spotlighted. So this week, we'll take a look at some of the other issues to consider when plotting out a rebalancing scheme.

Trading Can Be Costly

There is one very strong argument against becoming a rebalancing fanatic: Cost. When conducting our analysis two weeks ago, we assumed that all distributions were reinvested along the way, and did not factor in transaction fees or taxes on realized gains from trades. These are both very important issues to consider when thinking about a rebalancing strategy.

If you choose to rebalance annually (or even more frequently) in a taxable portfolio, carefully review how the various transactions you'll make will affect your tax return as well as any fees you might incur. A handful of questions to ask yourself are:

- Do funds in your portfolio have front- or back-end loads or short-term trading fees?
- Are you buying into a fund paying a distribution? (Some funds pay annually, others quarterly, for example.)
- Will the sale of a fund create a taxable gain? (This is obviously not an issue in tax-free accounts like IRAs and 401(k)s, but trading fees and loads should still be considered.)

Depending on how you answer those questions, you may realize that these hidden costs of rebalancing can quickly suck the wind out of your portfolio's sails and be a drag on your returns.

However, there are more ways to rebalance than just buying and selling out of the funds in your portfolio on a fixed schedule or when allocations get out of whack. One of the simplest to consider is redirecting distributions to or making new investments in the under-allocated funds in a portfolio. Or if you're at the point where you're using the portfolio for income, you could sell more of your winners' shares to reduce their allocation (this of course will generate its own tax bill, but you can't avoid taxes forever if you're drawing down your portfolio). These kinds of moves can be effective in keeping taxes and expenses down when compared to making numerous trades over the course of a year.

Maintaining Emotional Detachment

There's another issue at stake in rebalancing that often gets overlooked, and that's the human factor. It's easy enough to calmly discuss rebalancing a hypothetical portfolio, but when it comes to reality, many investors may find the idea counterintuitive, as it requires you to reward the losers in your portfolio with more money while reducing your exposure to the proven winners.

If you have a fund in your portfolio that's been outperforming month after month, you're probably not going to want to sell it to invest more in a fund that's been losing you money. But the standard theory of rebalancing requires that you do exactly that, and not just once, but over and over and over. As former Vanguard Chairman Jack Brennan put it: "If you are going to rebalance, you have to be absolutely clinical, or you are better off not doing it."

Of course, you could take the more laidback route and rarely rebalance—if at all—so long as you have a tolerance for the increased volatility that is part of an "unbalanced" portfolio. And when you consider the tax bill on frequent trades, you could come out substantially ahead. As illustrated by our analysis, from a returns standpoint, going with the flow isn't that bad of an idea.

Several additional things to consider:

- If you do choose to rebalance, either on a schedule or when your portfolio's allocation moves past a predetermined threshold, is your target allocation still appropriate? Do you still have the same investment goals as when you started? Has your risk comfort zone changed? Over the 27-year period such as the one we looked at last time, your allocation may no longer be a good fit, requiring even more buying and selling.
- Are you prepared for the headaches and tax implications of making multiple trades per year? While many firms allow you to make trades online, you still open yourself up to having to review more paperwork, track all of the changes to make sure there weren't any errors (on your part or the fund company's) and fill out extra lines on your tax return for every capital gain realized. This could add up to a lot of extra hassle, and it may be the biggest deterrent to tax-sensitive investors.

- If you're following a portfolio drift scheme, will you be able to stay on top of your portfolio and trade at the right times? As we showed last time, you could be in for both flurries of trades over a short time period and years without any activity by following this strategy. Since there's no routine, you'll need to pay close attention month in and month out to execute at the right times.

So is rebalancing necessary? Even though the media or your fund company may have you thinking so, when you look at the evidence—even after a five-year stretch as topsy-turvy as 2008–2013—there is little benefit when it comes to the portfolio's returns, and only some benefit when you think about risk. (Again, assuming no tax consequences or trading fees.)

Of course, if rebalancing frequently gives you peace of mind and you're willing to be clinical about it, your portfolio may not suffer too much for it either.

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