ADVISER INVESTMENTS

ADVISER FUND UPDATE

Market Summary and Commentary for Individual Investors from Adviser Investments

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Rebalancing Reconsidered

In a recent *Adviser Fund Update*, we put two rebalancing strategies—time-dependent and portfolio drift—recommended by Fidelity and Vanguard to the test. Running 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 15, 2016 update.

Readers responded with questions on rebalancing's role in risk prevention as well as about taxes, trading fees and other potential costs involved with the rebalancing strategies we spotlighted. This week, we'll take a look at some other issues to consider when plotting out a rebalancing scheme.

Managing Risk

You'll hear advocates of rebalancing (including fund companies like Fidelity and Vanguard) argue that it is a disciplined way to sell high (on what has done well) and buy low (on market laggards). By sticking to a defined allocation between stocks and bonds, risk-control rebalancers say, you can manage the overall risk or volatility of your portfolio through continuing market cycles.

Mathematically, this is absolutely true. A portfolio that is rebalanced often does exhibit lower volatility, resulting in a better risk-adjusted return over time, even if its total returns closely hew to or lag a never-rebalanced portfolio. What that risk control is worth to investors, especially when considering the costs, and the mechanical and emotional aspects we review below, is something that needs to be individually determined.

Our philosophy is to make strategic trades when opportunities present themselves rather than engage in regular or systematic trades (unless it's something specifically requested by a client).

The Costs of Trading

The strongest argument against becoming a rebalancing fanatic? Cost. When conducting our analysis in January, we assumed that all distributions were reinvested along the way, and did not factor in transaction fees or taxes on realized gains from trades—two 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. Ask yourself:

- 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 or monthly.)
- Will the sale of a fund create a taxable gain? (This is obviously not an issue in tax-deferred accounts like IRAs and 401(k)s, but trading fees and loads should still be considered.)

Answering these questions may help you 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. A simple idea is to consider 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 versus making numerous trades over the course of a year.

Maintaining Emotional Detachment
Don't overlook the human factor with regard to rebalancing. It's easy to calmly discuss rebalancing a hypothetical portfolio, but in reality, many investors may find the idea counterintuitive. It requires you to reward the losers in your portfolio with more money while reducing your exposure to 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 relaxed approach 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 decades-long 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 period of time and years twiddling your thumbs by following this strategy. Since there's no routine, you'll need to pay close attention—day in and day 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 six-year stretch as topsy-turvy as 2008 through 2015—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.

Vanguard Cuts Expenses on 24 Funds

Having already reduced expenses on a number of ETFs and index funds at the end of December, Vanguard stayed on the offensive in its ongoing fee war against competitors, cutting expense ratios on 24 funds' various share classes in the last week of January. The full list is available below.

As a reminder, an expense ratio tells shareholders how much they are paying to support the firm's annual cost of operating a particular fund or ETF. The expense ratio is calculated by dividing annual operating expenses for the previous fiscal year by the average dollar value of the fund's or ETF's assets under management.

Unlike the cuts in December, which saw reductions to fixed-income and sector index funds' fees, January's moves included 11 actively managed funds, as well as all 12 of the funds-of-funds Target Retirement series. Short-Term Inflation-Protected Securities Index also reported lower expense ratios for its three retail share classes.

We're always pleased to see fund companies cut costs for investors. When fund giants like Vanguard and Fidelity duke it out over the lowest costs, the real winners are investors who can keep more money in their accounts compounding over the long term.

January 2016 Fee Cuts

Fund	Share Class	Ticker Symbol	Former Expense Ratio	Current Expense Ratio
Capital Opportunity	Admiral	VHCAX	0.40%	0.38%
Capital Opportunity	Investor	VHCOX	0.47%	0.45%
Equity Income	Admiral	VEIRX	0.20%	0.17%
Equity Income	Investor	VEIPX	0.29%	0.26%
Global Equity	Investor	VHGEX	0.61%	0.57%
Growth and Income	Admiral	VGIAX	0.26%	0.23%
Growth and Income	Investor	VQNPX	0.37%	0.34%
PRIMECAP	Admiral	VPMAX	0.35%	0.34%
PRIMECAP	Investor	VPMCX	0.44%	0.40%
PRIMECAP Core	Investor	VPCCX	0.50%	0.47%
Short-Term Inflation-Protected Securities Index	Admiral	VTAPX	0.10%	0.08%
Short-Term Inflation-Protected Securities Index	Investor	VTIPX	0.20%	0.17%
Short-Term Inflation-Protected Securities	ETF	VTIP	0.10%	0.08%

Strategic Equity	Investor	VSEQX	0.27%	0.21%
Strategic Small-Cap Equity	Investor	VSTCX	0.38%	0.34%
Target Retirement 2010	Investor	VTENX	0.16%	0.14%
Target Retirement 2015	Investor	VTXVX	0.16%	0.14%
Target Retirement 2020	Investor	VTWNX	0.16%	0.14%
Target Retirement 2025	Investor	VTTVX	0.17%	0.15%
Target Retirement 2030	Investor	VTHRX	0.17%	0.15%
Target Retirement 2035	Investor	VTTHX	0.18%	0.15%
Target Retirement 2040	Investor	VFORX	0.18%	0.16%
Target Retirement 2045	Investor	VTIVX	0.18%	0.16%
Target Retirement 2050	Investor	VFIFX	0.18%	0.16%
Target Retirement 2055	Investor	VFFVX	0.18%	0.16%
Target Retirement 2060	Investor	VTTSX	0.18%	0.16%
Target Retirement Income	Investor	VTINX	0.16%	0.14%
U.S. Value	Investor	VUVLX	0.29%	0.26%
Wellesley Income	Admiral	VWIAX	0.18%	0.16%
Wellesley Income	Investor	VWINX	0.25%	0.23%

Source: Vanguard.

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Adviser Investments 85 Wells Avenue Newton, MA 02459 USA