ADVISER FUND UPDATE

ADVISER INVESTMENTS

Market Summary and Commentary for Individual Investors from Adviser Investments

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Reassessing Rebalancing
In our most recent *Adviser Fund Update*, we put two rebalancing strategies recommended by Vanguard and Fidelity—time-dependent and portfolio drift—to the test. Running through the data, we found that over nearly three decades, there was little difference in return between regular, periodic rebalancing, utilizing portfolio drift greater than 5% or 10%, and never rebalancing. For the details, please refer to our January 27, 2017 update.

Readers sent feedback with questions on rebalancing's role in risk prevention as well as taxes, trading fees and other potential costs involved with the rebalancing strategies we analyzed. This week, we'll take a look at these and other issues to consider in your approach to rebalancing.

Controlling Risk
Prominent advocates of rebalancing (including fund companies like Fidelity and Vanguard) often argue that it is a disciplined way to sell your winners high and buy market laggards on the cheap. 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 continuously through market cycles.

Mathematically, this is absolutely true. A portfolio that is regularly rebalanced typically 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 individuals need to determine for themselves.

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 to meet their financial or investment needs).

Trading Is Costly
The strongest argument against becoming a rebalancing fanatic? Cost. When conducting our analysis two weeks ago, we assumed that every distribution was reinvested along the way, and did not factor in transaction fees or taxes on realized gains from trades—two critical issues when thinking about a rebalancing strategy.

If you opt for annual rebalancing (or decide to do it even more frequently) in a taxable portfolio, carefully review how the various transactions you'll make will impact your tax return on top of any fees you might incur. Ask yourself:

- Do funds in your portfolio have front- or back-end loads or short-term trading fees?
- Does the fund you're buying make regular distributions? (Some funds pay annually; others quarterly or monthly.)

- Will selling your shares 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.)

Thinking through 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 simply 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 create its own tax liability, 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, at least when compared to making numerous trades over the course of a year.

Keeping Emotions in Check

You're only human. Don't overlook that when considering rebalancing. It's easy to calmly discuss rebalancing a hypothetical portfolio, but in reality, many investors may find the idea tougher to act upon. 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 lost 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 a decades-long period like the one we examined last time, your allocation may no longer be a good fit, requiring even more buying and selling.
- Are you prepared for the hassles 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 every change 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 of sitting idle 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, 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.

Schwab Ups the Ante in Fee Wars

Last week, Schwab fired another shot across Fidelity's and Vanguard's bows when it announced a plan to further reduce its index mutual fund's fees to align with the fund company's ETF equivalents, as well as eliminate all investment minimums for these passive investment instruments. As part of the move, Schwab also cut its ETF trade commission to be more competitive with the two firms.

Beginning March 1, 2017, Schwab's market-cap-weighted index mutual funds—S&P 500 Index, Small-Cap Index and U.S. Aggregate Bond Index—will be available to investors at expense ratios a fraction of those offered for similar products at Fidelity and Vanguard.

The reduction on Schwab S&P 500 Index will cut its expense ratio from 0.09% to 0.03%, while Schwab Small-Cap Index's expenses will go from 0.17% to 0.06%. Schwab U.S. Aggregate Bond Index should become available to investors on February 23.

Fund	**Investment Amount**		
	$3,000	**$10,000**	**$5,000,000**
Schwab S&P 500 Index	0.03%	0.03%	0.03%
Fidelity 500 Index	0.09%	0.045%	0.035%
Vanguard 500 Index	0.16%	0.05%	N/A
Schwab Small-Cap Index	0.06%	0.06%	0.06%
Fidelity Small Cap Index	0.19%	0.07%	0.06%
Vanguard Small Cap Index	0.20%	0.08%	0.07%
Schwab U.S. Agg. Bond Index	0.04%	0.04%	0.04%
Fidelity U.S. Bond Index	0.15%	0.05%	0.04%
Vanguard Total Bond Index	0.16%	0.06%	0.05%

Sources: Fidelity, Schwab, Vanguard. Note: Minimum Fidelity investment is $2,500 for Investor shares; $10,000 for Premium class of lower-cost shares. Minimum Vanguard investment $3,000 for Investor shares; $10,000 for Admiral class of lower-cost shares, and ETF shares have no minimums and the same expenses as the Admiral shares.

While we at Adviser Investments firmly believe in the ability of top active managers to outperform the market—and our own expertise in finding these managers—we're also happy to see any investor keep more of the money their investments earn. Index investors should cheer this move, and we'll be watching closely to see if and how Fidelity and Vanguard respond to Schwab's fee slash.

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Adviser Investments and its subsidiaries operate as an independent, professional money management firm with particular expertise in Fidelity and Vanguard mutual funds. We advise more than 3,000 clients and have over $4 billion under management. Our investment professionals focus on helping individual investors, trusts, foundations and institutions meet their investment goals. Our minimum account size is $350,000. In 2016, Adviser Investments was named to Barron's list of the top 100 independent financial advisers nationwide and its list of the top advisory firms in Massachusetts for the fourth consecutive year. We have also been recognized on the Financial Times 300 Top Registered Investment Advisers list in 2014, 2015 and 2016.

For more information, please visit www.adviserinvestments.com or call 800-492-6868.

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