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Rebalancing: Dull and Unimportant...Not!

FQ Perspective

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The conventional view is that rebalancing is a minor aspect of fund management, not worthy of much commitment of time or intellectual energy. That view is very, very wrong. In a world of lower returns, a world of little if any risk premium, rebalancing matters more than it ever has in the investment career of each and every one of us. Isn't this a brash statement, regarding one of the most passive and dull aspects of fund management? No.

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- As we've argued extensively over the past year or two, it is impossible to make a case for a large "equity risk premium" in the years ahead, without making some truly heroic assumptions about future economic growth, and the flow-through of that growth to the equity market investor. The best guess for equities, over the next ten or twenty years, is that returns will not be materially higher than bonds, and could easily be lower. Assuming this view is correct, bull and bear markets are not going to stop; they will simply be around a flatter "trend line." In this "new world," rebalancing becomes a far more reliable source of improved performance and an "anchor to windward," reducing risk as it improves returns. As the attached paper by Lisa Plaxco shows, the benefits of rebalancing are modest in a relentless bull market and *substantial* in a more steady market, where there is not one dominant asset class. Which are you expecting in the years ahead?

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- Future returns will be sharply less than the 15-20% that we have grown accustomed to. If, as we believe is true, future returns in the next ten to twenty years are likely to be 5-6%, and are likely to be negative as they are to be double-digit. A thoughtful market observer might peg expectations a touch higher (or lower ... see some of Jeremy Grantham's work!). Either way, adding a few tens of basis points per annum over a market cycle is an *important* improvement in returns, when returns are so modest.

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- Asset allocation decisions are not simple "yes or no" choices. The question is not, "should we do rebalancing?" The question is "*which* mechanism should we employ to respond to market movement?" Tactical asset allocation will typically respond to a newly-fallen market by buying (ceteris paribus). This is fine if we believe that a lower market typically means higher future returns. Rebalancing implies reverting to a fixed mix whenever there is a material departure from the intended policy asset mix. This is fine if we believe that markets are efficient and that a higher or lower market doesn't really change return prospects enough to justify an active asset allocation "bet." A drifting asset

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mix is a problem: it guarantees that you are overexposed at market tops and underexposed at market bottoms. It makes active tactical asset allocation “bets,” but they are accidental bets, driven by the whims of the markets. It is difficult, therefore, to justify by any sound fiduciary or theory arguments.

- For those who reject the active bets made by Tactical Asset Allocation, rebalancing is the most defensible, intuitive alternative. Yet, startlingly, we have encountered very few sponsors who have rejected TAA in favor of systematic, passive rebalancing. *Almost all* of our rebalancing clients are also users of TAA (using the rebalancing for the assets outside of the TAA program). Most funds that reject TAA instead tolerate some form of asset mix drift.

- The costs are negligible. Trading is modest and trading costs through futures are tiny. Fees, similarly, are tiny when measured against either the assets of the fund or the tens of basis points that are typically added at the fund level.

- Formalizing a rebalancing framework can help persuade the investment committee *not* to tinker with the asset mix in the all-too-typical ad hoc committee-meeting tactical asset allocation process. It creates a mechanism whereby the fund *can and will* buy when markets are newly-fallen or sell when markets are newly-costly, without provoking second-guessing by the investment committee or the all-too-common “let’s wait and see what happens first” decision-avoidance.

- It’s easy. There’s no excuse for *not* having some sort of rebalancing process in place.

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Evidence from Live Rebalancing Strategies

Attached is a summary of our own rebalancing composite. These strategies, for the most part, use a client's existing idle cash reserves for two purposes: equitizing those reserves and rebalancing to a policy mix. Some clients require passive rebalancing, exactly to the policy mix, whenever there is a departure from policy mix larger than 1% or 2%. Others allow us to tactically rebalance, whenever our tactical models suggest that it is timely and appropriate to do so. The difference between tactical rebalancing and tactical asset allocation is that with tactical rebalancing we can never actively take on a deliberate active position; we can only allow a mix which has already drifted away from the policy mix to stay as-is, until our tactical models suggest that things have gone too far. It's a subtle distinction, but tactical rebalancing obviously involves dramatically less tracking error and sharply less active bets than a true tactical asset allocation program. None of our tactical rebalancing clients allows us to permit an asset mix to drift more than 3% away from the policy norms.

With our equitization and rebalancing mandates, we find that the equitization of cash reserves adds tremendous value in a bull market (see the gains in 1997-1999). However, rebalancing opportunistically benefits from bear markets, which almost offsets the losses on cash equitization in bear markets (witness the surprisingly good results in the bear markets years 1994 and 2000). Cumulatively, since the beginning of 1992, when our first rebalancing clients started with us, rebalancing and cash equitization has gained these clients over 100 basis points (91 net of fees) per annum, with only 74 basis points of annual tracking error. Here, tracking error has a rather unusual definition: what we are really doing is ***reducing*** the tracking error that would have resulted from a drifting asset mix! So, our 74 bp tracking error, relative to the underlying assets is mostly a reduction in the tracking error that a drifting asset mix would have had relative to the intended policy mix! One of the most surprising exhibits is the rolling

12-month value-added chart. Over 12-month spans, this equitization and rebalancing has almost always added value for clients, except for a brief span in 1994, when rebalancing could not overcome the losses associated with equitizing cash reserves in a falling market. The most recent 12 months has seen a slender gain, even in the context of a very weak market.

We've published studies suggesting that the benefits of cash equitization and rebalancing are around 47 bp per annum, over the span from 1971-1990[1] around 41 bp per annum on a risk-adjusted basis even for rebalancing ***alone*** from 1968-1991[2] and 43 bp per annum for a UK rebalancing process from 1986-1994[3]. Tactical rebalancing, in simulation, adds nearly 100 basis points to global returns from 1986-1995, while reducing volatility[4]. Rebalancing also adds as much value as 11% increase in equity exposure in equities[5] and as much as 25% more in stocks if it's done in a globalized portfolio[6].

Does rebalancing matter? Is it worth the bother? You bet! Now more than ever.

Sincerely,

Robert D. Arnott

[1] *"Managing the Asset Mix", First Quadrant, 1990, No. 3.*
[2] *"Rebalancing: Why? When? How Often?", First Quadrant, 1992, No. 3.*
[3] *"Rebalancing to Benchmark", First Quadrant, 1994, No. 4.*
[4] *"Tactical Rebalancing", First Quadrant, 1996, No. 3.*
[5] *"Rebalancing: Why? When? How Often?", First Quadrant, 1992, No. 3.*
[6] *"Rebalancing to Benchmark", First Quadrant, 1994, No. 4.*

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