

# Rebalancing (investment)

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**Rebalancing** is the action of bringing a portfolio of investments that has deviated away from one's target asset allocation back into line. Under-weighted securities can be purchased with newly saved money; alternatively, over-weighted securities can be sold to purchase under-weighted securities.

## Rebalancing controls risk

The investments in a portfolio will perform according to the market. As time goes on, a portfolio's current asset allocation can move away from an investor's original target asset allocation. If left un-adjusted, the portfolio could either become too risky, or too conservative. The goal of rebalancing is to move the current asset allocation back in line to the originally planned asset allocation.

## Rebalancing bonus

While investors primarily use rebalancing to control portfolio risk, there are a set of circumstances where rebalancing will actually boost the performance of a portfolio. This performance boost is known as the rebalancing bonus. The conditions necessary to support this rebalancing bonus include:

- Uncorrelated or negatively correlated assets – Positive correlation among asset classes will render rebalancing less meaningful.
- Mean reversion properties – When assets behave with a tendency to revert to the mean, then it is more likely that the asset will appreciate at a higher rate than its mean if it has underperformed in the past periods. Rebalancing serves to move investment dollars into underperforming asset classes which are more likely to perform better in the future. Equities appear to demonstrate mean reversion properties for some periods of time while displaying more trending behavior in other periods.
- Similar rates of returns for assets – If one asset class has a significantly higher mean rate of return, then rebalancing can reduce the overall portfolio's performance. In this case, the rebalancing will move funds away from the fastest growing asset class.
- High variances within individual asset classes – High variance leads to the situations where asset classes will (1) substantially outperform the portfolio for periods (during which time the rebalancing will take profits out by selling these shares) and (2) substantially underperform the portfolio in other periods (when the rebalancing will buy

shares at the reduced price). The net, long-term result of these swings will be higher return for the overall portfolio.

The rebalancing bonus will not be achieved by all portfolios but it can happen if the above conditions are met. On the other hand if these conditions are not met then rebalancing may hurt performance. For example rebalancing between stocks (with a higher rate of return) and bonds (with a low rate of return) may cause the portfolio to grow more slowly than a nonrebalanced portfolio (where the stocks grew to a larger and larger percentage of the portfolio over time).

## Rebalancing strategies

There are many possible rebalancing strategies. The exact choice is probably not too important, as long as the rebalancing is performed consistently.

- Rebalancing every year:

Rebalancing at exactly the same time each year is easy to remember.

- Rebalancing every 15 months:

The hope is to make a sale qualify for long term capital gain in the United States.

- Rebalancing when current allocation is 5% off from target asset allocation:

Touch nothing except when allocation is off noticeably.

## Opportunistic Rebalancing: A New Paradigm for Wealth Managers

by Gobind Daryanani CFP®, Ph.D.

### Executive Summary

- Wealth managers traditionally rebalance portfolios quarterly or annually to control risk due to asset class drifts. This paper proposes a new paradigm for planners: rebalance less frequently, but look more frequently to find the best opportunities for rebalancing.
- The proposed approach, called opportunistic rebalancing, not only controls portfolio drift, but also provides significant return improvements by capturing buy-low/sell-high opportunities as asset classes sporadically drift relative to each other.
- The paper studies a wide range of market conditions to show that rebalancing return benefits can be more than doubled compared with the traditional annual rebalancing.
- These additional benefits, attributed to transient momentum and mean reversion effects, occur sporadically in time and can only be captured by monitoring portfolios frequently.
- The studies suggest these practical guidelines: (1) use wider rebalance bands, (2) evaluate client portfolios biweekly, (3) only rebalance asset classes that are out of balance—not classes that are in balance, and (4) increase the number of uncorrelated classes used in portfolios.
- The studies show that trading costs and tax deferral are small compared with rebalance benefits.
- Opportunistic rebalancing has already been adopted by a number of leading wealth management firms across the country.

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Wealth managers traditionally rebalance portfolios quarterly or annually to control risk due to asset class drifts. But there's a new paradigm for planners: rebalance less frequently, but look more frequently to find the best opportunities for rebalancing.

This "opportunistic rebalancing" approach not only controls portfolio risk, but also provides significant return improvements by capturing sporadic buy-low/sell-high opportunities as asset classes drift relative to each other. We will show that, with frequent looking, rebalancing return benefits are significantly improved compared with traditional quarterly or annual rebalancing. For example, by looking frequently but rebalancing only when needed, the average rebalancing benefits are shown to be more than double the benefits of more traditional annual rebalancing.

Of course, a variety of factors may have an effect on rebalancing, so we will discuss sensitivities to historical periods, rebalance bands, rebalancing frequencies, and trading costs and tax costs, for different rebalance methodologies. We will also consider the operational costs of incorporating opportunistic rebalancing in individual planning firms.

Our conclusion is that the average benefits of opportunistic rebalancing far outweigh the costs.