The Art Of Portfolio Rebalancing

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In volatile markets, investors are normally faced with an emotionally difficult choice. They have various choices i.e to sell something which is not doing very well to buy something which is doing very well or vice versa. Or they may allow their portfolios to drift significantly away from their target asset allocations and decide not to do anything. While logic may be on the side of rebalancing but there is a strong temptation to let the money ride. Emotions of fear or greed come into mind and one tends to follow the asset classes that are doing well rather than rebalancing the portfolios.

Even today, we are facing a similar situation where equity markets have moved up by about 30 per cent in the recent past. Investors who have made good returns in the equity markets are looking at investing more. Some who did not invest before into equities feel they have missed something. The element of fear is turning into an element of greed and hence everyone wants to expose more into equities now than what they would have done a year back.

The outcome could be seen in the gross sale of mutual funds which is positively correlated to the equity market movement. If market moves up, the sales of equity mutual funds go up and vice versa. Frankly, these are tough times for investors to take any decision on buying, selling or holding an asset class. And it is even tougher for an investment advisor to advise correctly if one does not follow the rules on strategic Asset Allocation and rebalancing of portfolios.

Once the Strategic Asset Allocation (SAA) is defined for an investment portfolio and investments done as per the SAA, various asset classes would start growing at different rates. This would happen as certain assets that are growing faster will see their allocation increase or assets that are growing slower will see their allocation decrease. This would disturb the SAA of the portfolio and hence the return expectation and risk profile too.

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Once this happens, one should rebalance the portfolio and comeback to the SAA. The portfolio rebalancing could happen in two ways Sell the asset class, whose allocation has increased to the extent of increase, to buy the asset class whose allocation has decreased. Fresh inflows could get into the asset class whose share has reduced, which could bring the asset allocation closer to the initial asset allocation.

Example: Let us say an entity starts with a 70:30 Debt to Equity Allocation. Equity market moves up and equity component becomes 40 per cent of the total portfolio. At this point in time one should sell the additional 10 per cent equity and buy debt with the sale proceeds and come back to the initial asset allocation of 70:30. Alternatively, one could invest only into debt with the fresh surpluses to come back to the desired asset allocation.

Some of the benefits of Portfolio rebalancing are:

It will always help to buy an asset class, whose allocation has gone down in the portfolio and sell an asset class whose allocation has gone up in the portfolio. Following this one would always buy when the market (both debt & equity) is low and sell when it is high. The risk as measured by Standard Deviation goes down. The Sharpe ratio or return per unit risk of the portfolio improves. It takes away the elements of emotions in managing one's portfolio and brings discipline while investing.

Factors like transaction costs, liquidity & taxation should be taken into consideration while rebalancing. It should not happen that the cost of these factors exceeds the benefits of rebalancing. One way of mitigating effects of taxation and transaction costs would be to invest periodically and invest in the asset class where allocation has become too low.

The big question would be 'How often should one rebalance the portfolio?' There are two techniques followed in this. One is time based and secondly on the extent of disturbance in a portfolio.

Historical data in an emerging market like India proves that it makes sense to rebalance the portfolio once in six months. Else one should rebalance once the allocation is disturbed more than 5 per cent from the Strategic Asset Allocation in a 50:50 portfolio, 4 per cent in case of a 40:60 portfolio and 3 per cent for a 30:70 portfolio. Keeping in mind the techniques of rebalancing, one should be looking at selling a part of their equity portfolio and go back to the asset allocation what was there six months ago. ◆

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