

INSTITUTIONAL PERSPECTIVE

Rebalancing Reset: A New Approach in a New World of Institutional Investing

Rebalancing is a well-known portfolio management strategy; however, like all strategies, its effectiveness depends on the accuracy of underlying drivers and assumptions. For most institutional investors, rebalancing instructions are defined in the Investment Policy Statement (IPS) and they are implemented based on strategic allocation weights or “targets.”

One potential problem is that once these instructions are established in the IPS, many institutional investors automate the rebalancing process. While this has long been the case, recent unprecedented market conditions have created a new paradigm for investment management. Rebalancing is just one area where institutional investors should re-consider their approach and look for new views and perspectives.

This paper outlines new considerations in rebalancing strategies given recent market events, as well as new research on institutional investors that gauges current rebalancing strategies.

How are Institutional Investors Currently Rebalancing?

To gain a better understanding of current rebalancing strategies, SEI conducted a survey of institutional investors outside its client base. SEI polled 119 institutional investors during December 2008 and January 2009. The executives polled oversee institutional assets in either the US or Canada ranging from \$25 million to more than \$1 billion. The survey assessed when rebalancing took place, how it was implemented and if market conditions had changed approaches.

Traditionally, many institutional investors rebalance in response to pre-set triggers, such as when the ratio between the percentage of stocks and bonds in a portfolio exceeds a set amount. For example, consider a +/- 5 percent trigger or tolerance band on a portfolio with an asset allocation of 60 percent US equity and 40 percent US fixed income. If equity rallies and their prices rise while fixed income slumps and prices decline, the portfolio's asset allocation may become 66% US equity and 34% US fixed income. With pre-set triggers in place, this portfolio would automatically be rebalanced.

▪ Rebalancing Destinations

Almost three-quarters (73 percent) of those polled said their organization's rebalancing policy mandates a return back to the “target” allocation instead of the high end of the tolerance band. Using the above example, this would mean a 6 percent reduction in the US equity position, with the proceeds invested in fixed income to return the portfolio to the desired 60/40 mix.

An alternative would be to rebalance to the high end of the tolerance band. Interestingly, of poll respondents, 27 percent said their rebalancing policy dictates this method. This would mean a 1 percent to 2 percent reduction in the equity position, which would return the allocation to within the +/- 5% band.

- **Frequency**

The frequency of rebalancing varied across poll respondents as 44 percent said their rebalancing policy calls for quarterly rebalancing, 29 percent said annual rebalancing and 27 percent said monthly. Of the group rebalancing quarterly, 63 percent said they rebalance off-cycle (e.g. March, June, etc.) and the remaining 37 percent said they rebalance at the fiscal quarter-end (e.g. April, July, etc.).

- **Tolerance Bands Across Asset Classes**

The survey asked respondents whether or not their organization's rebalancing mandate called for the same tolerance bands for all asset classes. Of the organizations polled, 61 percent said they do not have the same tolerance band for all asset classes used in the pension portfolio.

- **Rebalancing in Current Markets**

Conventional thinking suggests that rebalancing is the appropriate move in volatile markets. Poll respondents supported that notion as almost three-quarters (71 percent) said their organizations continued to rebalance throughout the market volatility experienced in 2008.

New Considerations for Rebalancing

The traditional approach to rebalancing is based on triggers written into an investment policy statement (IPS). Those triggers automatically determine when rebalancing occurs and how the portfolio is rebalanced. The rationale for a less automated approach is compelling, especially during periods of market distress, which generally causes the following events:

1. Liquidity decreases (especially in distressed securities) in response to fear, which drives rebalancing costs upward
2. Volatility increases
3. Correlations between asset classes rise as the event spreads across markets
4. The greater the event, the more the market becomes dominated by trend-following (fear) as opposed to mean reversion

With that as a backdrop, institutional investors should consider a rebalancing policy that is more flexible and less mechanistic. Below is an outline of areas where this can be addressed:

- **Dynamic timing**

Rebalancing is a risk management function that should be used when it is most needed and when it benefits the overall portfolio. Continuous oversight and the option to dynamically time when rebalancing is needed is important to the overall process. Organizations that rebalanced either quarterly or annually (73 percent of those polled) would have endured the worst of the market downturn (Q4 2008) without a reallocation. While organizations with monthly rebalancing policies would have made changes, an automated process would have purchased more of an asset class as it continued to trend downward.

Additionally, the expenses involved with rebalancing are also dependent on timing. Liquid markets favor more frequent rebalancing, whether fully or partially back to target. Illiquid markets substantially increase the transaction costs, yielding a desire for less frequent rebalancing. These are all considerations that should be taken into account when rebalancing. While investors might want to

consider rebalancing at least quarterly, a policy that allows for dynamic timing creates additional flexibility which can be an advantage during tougher times.

- **Flexible rebalancing bands**

Rather than having a fixed threshold as the trigger, institutions might want to consider setting varying bands or thresholds to trigger rebalancing. Those bands should be designed to provide optimal flexibility especially in times of market distress. If a fixed trigger is in place, a portfolio manager cannot allow the trigger to move higher during extreme market conditions even if they feel it will benefit the investor. A 2 percent to 10 percent varying band, for example, would provide that portfolio manager with the ability to consider market conditions and make calculated judgments. More than half of the survey respondents (61 percent) said their organizations' current rebalancing policy already provides different tolerance bands for different asset classes. Using a varying band would provide increased flexibility within those asset classes.

Furthermore, the same flexibility should be provided when determining the target to which each asset class is rebalanced. The results of the survey show that investors have traditionally used a rebalancing destination of back to target, with more than three-quarters of those polled indicating that they currently operate this way. Institutional investors might want to consider implementing a policy that provides the portfolio manager with the option of choosing to rebalance back to target allocations, to the high end of the band or even somewhere in between. Market distress can cause liquidity decreases, greater volatility, trend following and the potential for asset classes to exhibit far higher correlation. Investors should consider these factors when determining the proper rebalancing policy.

- **Temporarily Suspending Rebalancing**

As the fourth quarter of 2008 and the early portion of 2009 have demonstrated, automatic rebalancing – even with the above mentioned varying bands – limits the ability to mitigate potential negative results.

The ability to temporarily “turn down” rebalancing provides portfolio managers with a way to judge if it appears that an additional exposure might have a negative effect on the portfolio.

The decision to tighten the rebalancing tolerance bands again is dependent on mean reversion occurring. Generally, stable markets favor rebalancing most, as recent winners are sold and underperformers are bought in advance of the next reversion – where the previous out-performers and under-performers reverse positions.

Upon examination of the evolution of the current financial crisis, an argument can be made that there were risks that automatic rebalancing presented. However, the vast majority of organizations surveyed said they continued to rebalance. Consider the following scenarios and their implications:

- Traditional mean reverting environments, in which leaders and laggards change roles, are a prerequisite for generating positive results from rebalancing.
- Trend-following (fear/greed driven) markets present a less certain environment for a positive outcome.

- The costs of rebalancing are mainly driven by liquidity. When liquidity evaporates, the costs rise, blunting or negating the potential benefits of rebalancing.

In reviewing the fourth quarter of 2008, had the ability to temporarily “turn off” or “turn down” rebalancing been provided, portfolio managers could have helped organizations avoid additional equity exposure in their portfolios. Given the subsequent equity performance in the fourth quarter, the end result may have been fewer losses in the overall portfolio.

Conclusion

Rebalancing is a time-tested risk management strategy for portfolio management. However, the recent behavior of the financial markets has resulted in the need to re-examine this process.

While rebalancing is an important strategy that should continue to remain in place, institutions should consider revisiting their policies and implementing a less static approach. The changes outlined in this paper should be considered in the context of adjusting the long-term strategic asset allocation for the overall portfolio.

The flexibility suggested in this perspective will allow for intermediate term deviations from the strategic allocation – it is not tactical asset allocation which is very short-term focused. The movement away from rigid, automatic rebalancing is designed to provide the ability to avoid potential risk with the full intention to rebalance within more stable markets. This could provide portfolio managers with increased flexibility in navigating distressed markets and ultimately a more productive rebalancing process.

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