REBALANCING ACT

This is one of a series of Research Briefs created by Brinton Eaton to keep our clients informed about key developments — in financial planning, tax strategy, and investment management — that we research and implement as appropriate on your behalf.

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In several of our other *Research Briefs*[1], we have made casual reference to (behind-the-scenes) portfolio rebalancing in illustrating the results of various investment strategies. In this *Research Brief*, we address more explicitly the unseen benefits that scientific rebalancing can bring to a portfolio.

Rebalancing, Not Reallocating

First, let's describe what we mean by rebalancing, since there are some common misperceptions.

Rebalancing entails the buying and selling of various investments within your portfolio to achieve a certain allocation by asset class. Does this represent a reconsideration of the asset allocation you specified in your Investment Objective Confirmation (IOC) or a departure from our underlying philosophy of investing for the long term? No, and no — in fact, just the opposite in both cases.

Your investment portfolio is first established according to an overall strategic allocation to three broad asset classes (fixed income, equity, and alternative investments). Within each of those broad classes, we then adhere to a more refined allocation scheme that establishes, for example, how fixed income investments should be spread among various maturities, and how equity investments should be spread among various industry sectors[2]. Once achieved, your actual allocation on any given day thereafter is then subject to the vagaries of the market. Each investment will increase (or decrease) in value more or less than the others in your portfolio. Over time, your allocation may drift sufficiently that it falls outside the tolerance bands we have set around each asset sub-class. When this occurs, we rebalance your holdings to get your portfolio back to its intended allocation.

Is That Such A Good Idea?

Wait, you say. Doesn't this mean that we'd be selling out of the winners and buying into the losers? Exactly.

The reason that this is an advisable activity is based on technical arcana (such as volatility, independence/correlation, and mean reversion) but can be grasped easily from the following table. This display, which the investment community likes to call a "periodic table", ranks each asset class according to its annual total return, with the best-performing investments each year at the top and the worst-performing at the bottom.

[1] For example, "Risk and Return" and "Portfolio Magic"

[2] The derivation of these lower level allocations (and the tolerance bands we establish around them) is quite involved and beyond the scope of this current *Research Brief*. The underlying approach is consistent with the portfolio concepts explained in our above-referenced *Briefs*. We would be pleased to discuss the details with you if you are interested.

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Commodities 49.7%	Real Estate 12.3%	Commodities 32.1%	Emerging Markets 56.3%	Real Estate 33.2%	Emerging Markets 34.5%	Real Estate 36.0%	Emerging Markets 39.8%	Fixed Income 5.2%	Emerging Markets 79.0%
Real Estate 31.0%	Fixed Income 8.4%	Fixed Income 10.3%	Small Cap Stocks 38.8%	Emerging Markets 26.0%	Commodities 25.6%	Emerging Markets 32.6%	Commodities 32.7%	Small Cap Stocks -31.1%	Mid Cap Stocks 37.4%
Mid Cap Stocks 17.5%	Small Cap Stocks 6.5%	Real Estate 3.6%	Real Estate 36.2%	Small Cap Stocks 22.6%	Real Estate 13.8%	Large Cap Stocks 15.8%	Mid Cap Stocks 8.0%	Mid Cap Stocks -36.2%	Real Estate 28.5%
Small Cap Stocks 11.8%	Mid Cap Stocks -0.6%	Emerging Markets -6.0%	Mid Cap Stocks 35.6%	Commodities 17.3%	Mid Cap Stocks 12.6%	Small Cap Stocks 15.1%	Fixed Income 7.0%	Large Cap Stocks -37.0%	Large Cap Stocks 26.5%
Fixed Income 11.6%	Emerging Markets -2.4%	Mid Cap Stocks -14.5%	Large Cap Stocks 28.7%	Mid Cap Stocks 16.5%	Small Cap Stocks 7.7%	Mid Cap Stocks 10.3%	Large Cap Stocks 5.5%	Real Estate -39.2%	Small Cap Stocks 25.6%
Large Cap Stocks -9.1%	Large Cap Stocks -11.9%	Small Cap Stocks -14.6%	Commodities 20.7%	Large Cap Stocks 10.9%	Large Cap Stocks 4.9%	Fixed Income 4.3%	Small Cap Stocks -0.3%	Commodities -46.5%	Commodities 13.5%
Emerging Markets -30.7%	Commodities -31.9%	Large Cap Stocks -22.1%	Fixed Income 4.1%	Fixed Income 4.3%	Fixed Income 2.4%	Commodities -15.1%	Real Estate -17.6%	Emerging Markets -53.2%	Fixed Income 5.9%

Source: compiled by Brinton Eaton based on data from Morningstar Encorr.

What is immediately clear from this exhibit is the substantial amount of churn within the list. No asset class maintains its spot in the rankings for very long, and there is no discernable pattern to how any one class moves up or down the list from year to year. At more frequent intervals than annual, the churn is even more pronounced. There is simply a lot of volatility in the market, and at this level of detail the movement is, in large part, unpredictable[3].

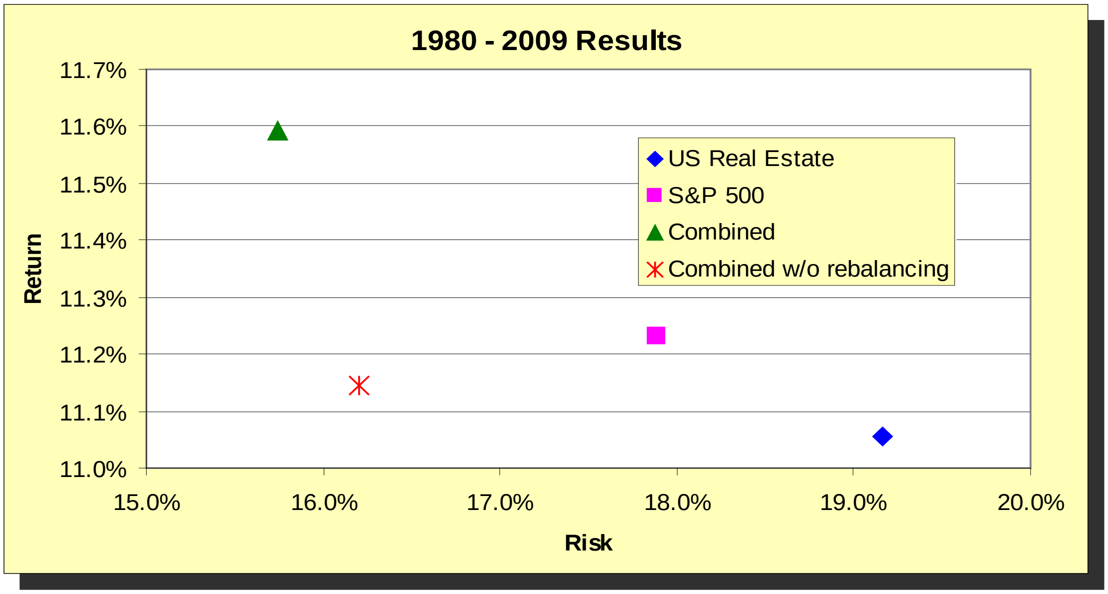
Here's the crucial point: *What rebalancing does is put this volatility to work for you*. And it does so without having to take sides — without having to make a bet on which asset class will be the new "flavor of the month" at any point in time. At the risk of over-simplifying[4], rebalancing imposes a discipline which essentially forces you to buy low and sell high — the goal of any winning investment strategy.

The Benefits

So, what does rebalancing do for you in terms of actual portfolio performance? Here's an example, using one of the results from an earlier *Research Brief*. To the following chart, from "Portfolio Magic," we have added an additional data point. Before we describe the new addition, recall that the original *Brief* concluded from this chart that "by combining assets, you can get a portfolio with less risk than you get with any one asset alone" and "by combining assets appropriately (and regularly rebalancing), you can get a return for the portfolio that is greater than the return for any asset within it!".

[3] This is not to say that *all* market movements are *completely* unpredictable. For example, there is a tendency for some investments, such as commodities, to do relatively well during periods of high inflation, and some equity sectors, such as consumer staples and healthcare, to do relatively well during periods of high investor pessimism. We can and do exploit these tendencies on your behalf. But that is not the crux of this particular story, which is focused on movements that are intrinsically unpredictable.

[4] The less simple explanation, for the technically inclined, can be found in our paper "The Alchemy of Risk Management"



The additional data point demonstrates how much rebalancing itself brings to the party. It (the orange star) shows what happens if you simply combine the assets without rebalancing between them each year — you get the reduced risk, but not the improved return[5].

Tying It All Together

This and two of our other *Research Briefs* are actually all pieces of a more complete investment management picture. In *"Risk and Return* , we explored the yin/yang nature of risk and return and the noteworthy things that happen when an asset is held over extended periods. In *"Portfolio Magic*," we added the dimension of multiple-asset portfolios, and illustrated the almost magical things that occur when assets with complementary risk profiles are combined in informed ways. And in this current *Brief*, we identified how integral to the process is the frequently overlooked and often misunderstood practice of systematic portfolio rebalancing.

These interrelated fundamentals guide the decisions we make on your portfolio every day.

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[5] As before, these results do not consider the transaction cost of rebalancing. In the more detailed work we do to support your actual portfolio management, we model and explicitly treat this cost, and determine optimal rebalancing trigger points accordingly. We also strive to accomplish the rebalancing trades with minimal tax impact.