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## A Balancing Act



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Source: Getty Images

If you have ever seen a high wire act, most wire walkers will carry a balancing pole to help with stability. The physics behind why this helps revolves around inertia. If you remember back in the days of high

school (for me that was a long time ago), inertia is the measure of an object's opposition/resistance to change in its direction of rotation (also referred to as rotational inertia).

There are numerous instances when rotational inertia appears in our daily lives. For instance, as a cyclist, I know if I peddle my bicycle, I will remain upright and balanced because of rotational inertia. Another example of rotational inertia seen every four years is figure skaters who pull their arms in to reduce their rotational inertia to spin faster. Inertia is everywhere.

For high-wire walkers, holding on to a balancing pole horizontally in their hands, the walker increases his/her moment of inertia and minimizes the body's "rotation" around the rope. The longer the pole, the more stability a walker has. The reason for this is the combined mass of the walker, and the pole is spread over the wire far away from the pivot point at the walker's feet. The bar reduces the angular acceleration of the tightrope walker as more torque is required to rotate the walker. So, if the walker tips over or loses their balance, he/she would do that very slowly and therefore have more time to correct his/her stance.

### **This paper isn't a science lesson, but one about your portfolio**

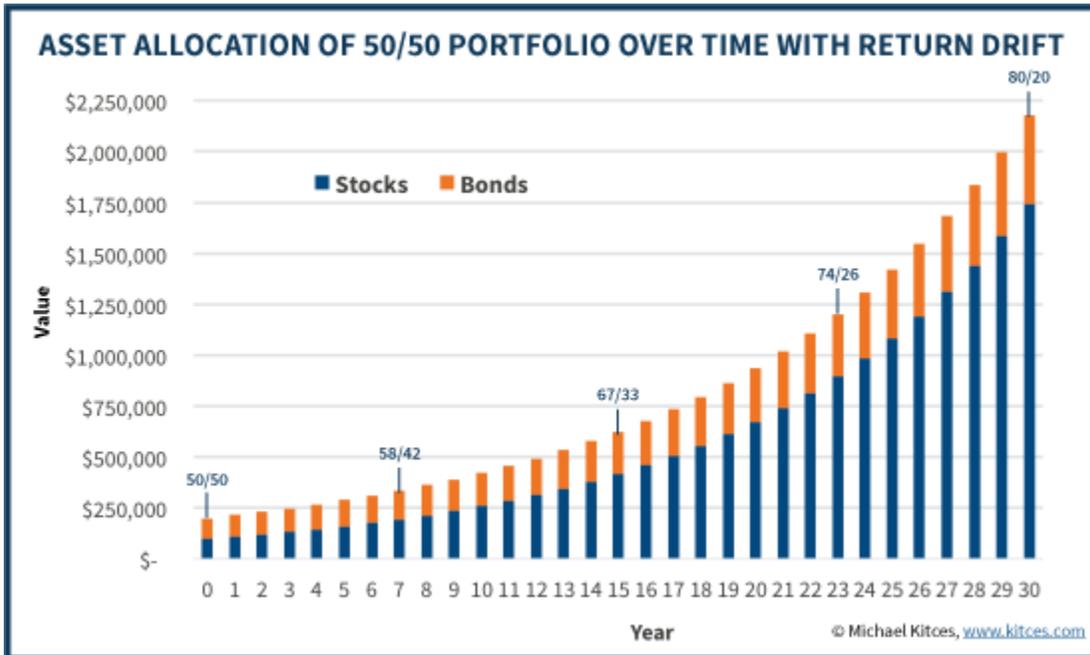
So you're probably wondering how I am going to "connect the dots" from something we see at the circus versus your portfolio (although a lot of people in my position are called "clowns" so there may be even more parallels). The answer revolves around the basic concept of portfolio rebalancing.

As the name implies, the idea is to realign the balance of investments in a portfolio, generally to stay close to original target weightings for that particular portfolio. And in a world where asset classes can have materially different long-term returns, this is crucial to ensure the portfolio components do not compound over time to the point of violating the investor's risk tolerance.

### **Portfolio rebalancing usually reduces returns, but it also reduces risk**

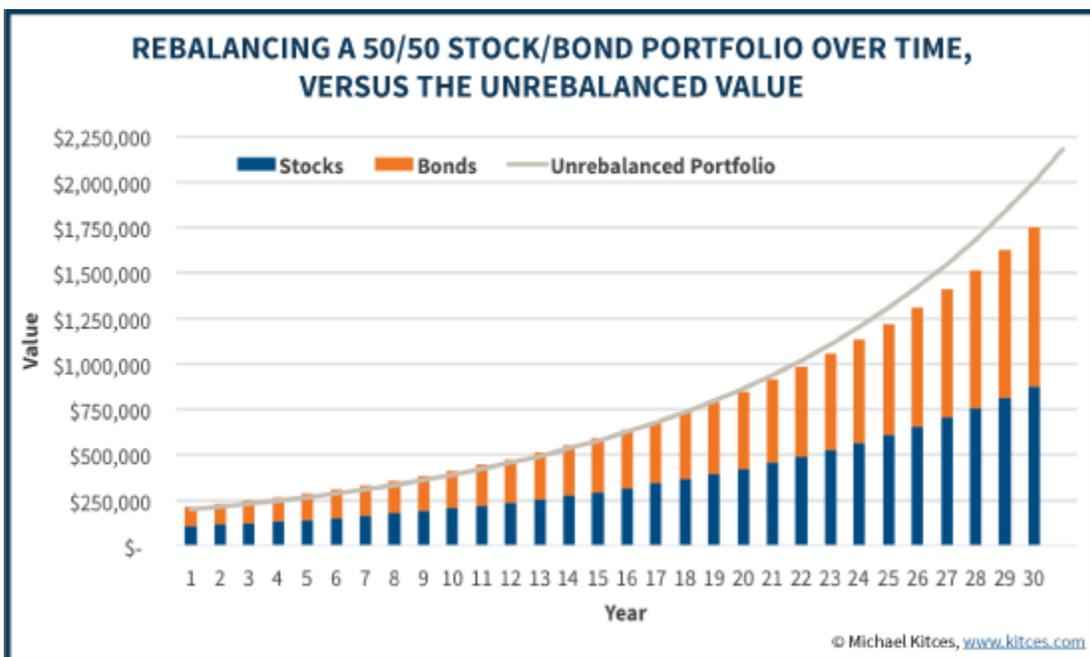
Consider for a moment that according to Blackrock Investment Institute, the historical (past tense) long-term return on stocks has been approximately 10% per annum (9.9% to be exact), while the long-term return on bonds (average investment grade classes) is approximately 5%. As the chart on the next page illustrates, a theoretical portfolio that is allocated 50/50 to each, and buys and holds those assets classes for the long run, will grow the stock portion at approximately 10% per year compounding, while the bond portfolio will only grow at a 5% per year rate. Which means that with growth, the percentage of the portfolio allocated to equities will become larger over time. Remember, this is theoretical.

As you look at the chart, the "bad" news of this scenario is that over time, the excess returns of the stocks over bonds will cause stocks to become a larger and larger portion of the portfolio. What starts as 50/50 portfolio drifts to 67/33 by 15 years, and nearly 80/20 after 30 years! Thus, just buying and holding a stock/bond portfolio will eventually lead to equity exposure to become far greater than what was originally intended, and most likely greater than what the client can tolerate.



Source: CBS MarketWatch & M Kitces

However, by rebalancing to bring target weighting back in line, the cumulative portfolio returns can be reduced, not enhanced. After all, rebalancing in this scenario will in-effect sell the higher-returning asset (stocks) and buy more of the lower-returning asset (bonds), potentially dragging down the long-term return.



Source: CBS MarketWatch & M Kitces

As seen on the previous page, the process of rebalancing to prevent equity exposure from drifting higher also curtails the favorable returns that come with allowing equities to compound. The portfolio that starts at \$100,000 each in stocks and bonds is rebalanced only grows to \$1,750,991 over time, compared to the buy-and-hold-and-don't-rebalance portfolio that grew to \$2,177,134. That's a difference of \$426,143.

Now, the latter portfolio only grew because the equity exposure was allowed to drift higher (and possibly beyond the client's tolerance), and in this example, there was no volatility. The process of rebalancing can sometimes be discussed to clients as a portfolio enhancement, but after reviewing many studies on this issue,<sup>i</sup> I have come to a conclusion that if not done properly, it could be a detriment to returns. But, the important factor for clients to remember is portfolio rebalancing *is* important and necessary to manage a client's risk.

So the question becomes, what's the optimal "balance" to extract the most return while keeping risk in check.

### Rebalancings simple steps

Most academic finance journals recognize three rebalancing methods to help clients maintain the proper risk tolerance. The three rebalancing methods are:

- **Frequency-based:** most often used by advisors, this is monthly, quarterly, semi-annual and annual rebalancing of all asset classes to their initial allocations.
- **Threshold-based:** rebalancing when allocations break out of ranges around asset classes and/or individual product selections.
- **Risk-based:** this seems to consensus in various studies I have read as one of the better ways to rebalance portfolios (but like anything in the market, it's not perfect). The idea is for rebalancing to take place after a tracking error target versus a benchmark is violated (and rebalancing magnitude is consistent with the threshold method).

In a study performed by Morningstar & Northern Trust (see chart on the next page), these three methods performed differently in various kinds of markets. The important conclusion is that periodic rebalancing with the exception of monthly, generally outperformed buy-and-hold (BAH) with higher returns, lower risk, and higher efficiency over a *full market cycle* (9/30/1995 until 12/31/2017).

Annual returns ranged from a high of 7.8% for risk-based tracking error rebalancing to a low of 7.3% for other methods. The risk-based tracking error method also came out on top for its efficiency ratio over the period.

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<sup>i</sup> Portfolio Rebalancing – Hype or Hope? White Paper By Ajit Dayanadan and Minh Lam

Portfolio Rebalancing to Overcome Behavioral Mistakes in Investing – Journal of Behavioral Studies – By Steven Beach and Clarence Radford

Portfolio Rebalancing Research: Momentum and Tolerance Bands – Alpha Architect – By Andrew Miller

Portfolio Rebalancing: How and How Often? By Laura DiPoce and Daniel Phillips

FULL PERIOD PERFORMANCE	Buy-and-hold	FREQUENCY			THRESHOLD		RISK-BASED
		Monthly	Quarterly	Annually	Absolute threshold to target	Half-Back	Tracking Error
Return (%)	7.2	7.1	7.3	7.5	7.5	7.5	7.8
Excess over BAH (%)	--	(0.1)	0.1	0.3	0.3	0.3	0.6
# times rebalanced	--	266	89	22	19	31	9
Standard deviation (%)	9.4	8.3	8.3	8.1	8.3	8.5	8.4
Efficiency ratio	0.8	0.9	0.9	0.9	0.9	0.9	0.9
Equity style drift	6.0	0.8	1.2	2.0	2.3	6.1	4.5

Source: Morningstar & Northern Trust

Absolute +/-4% Asset Class Weight, +/-5% Fullfillment Weight

Relative +/-10% of Asset Class Weight, +/-30% Fullfillment Weight

Risk Based: Trigger at a tracking error of 1%

## The cost of rebalancing

Cost also has an impact on rebalancing considerations outside the scope of the chart above. The decision to rebalance depends on the type of rebalancing cost. When trading cost are mainly fixed (independent of the size of trade), rebalancing to the longest frequency (one year + one day) is generally optimal to avoid the need for frequent transactions and long-term capital gains tax treatment.

The below are general rules of thumb to consider when transaction costs are incurred each you rebalance:

- All else being equal, it is better to set wider corridors for illiquid investments with high transaction cost, such as real estate and private equity.
- If the portfolio is in a taxable account, set wider bands compared to those of a tax-deferred account (this will help minimize capital gains tax/loss on the transactions).
- In tax-deferred accounts (IRAs and 401K's) use incoming contributions as a way to rebalance allocations that are beyond the risk bands.

## Investor inertia

Advisors and investors would be wise to think about portfolio rebalancing similarly to high-wire walking. As the walker looks for the pole to help them with balance, they understand "the longer, the better." The practical advantage to waiting as long as possible to rebalance a portfolio outweigh the deficiencies. This has been proven in numerous studies. These studies have also proven that rebalancing is best suited for risk reduction rather than a return enhancements. In a portfolio, it seems alpha (additional returns) can be better generated through rebalancing by reducing "max draw downs" instead of implementing an "opportunistic style tilt."

Just as careful construction of a portfolio design around an investors risk is critical to success, so is the strategy behind portfolio rebalancing. Advisors and investors should discuss their strategy around the client goals and expectations frequently. Optimization of the portfolio structure is critical to our clients and our advisors at Lakeview. We appreciate your trust.

I wish you well walking the wire. Until next time.

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