Two Ways to Make More Profits Rebalancing Your Portfolio

As we roll into the end of the year, you will hear talk of rebalancing portfolios. But I ask the question:

Why?

Balancing based on a calendar offers little more than underperformance over the long haul. Granted, when we look at short-term time periods, we can be fooled by this idea. Bull markets can fool us. Trends can fool us. The past few years held both and might give some the perception that rebalancing every year or even every six months is the way to go.

I won't even waste your time discussing annual rebalancing. If you are doing this, stop, just stop. You're just as well to rebalance every time your great Aunt Betty randomly calls you.

So, let's move forward to semi-annual balancing.

Semiannual rebalancing doesn't look too bad if we look at the SPDR S&P 500 ETF (SPY) over the past four years. But, let's be honest, it doesn't look all that great either. The results resemble more of a coin flip. The years 2017, 2019, and 2020 (probably) all went out near highs, while 2018 went out near lows. Those do make opportunistic rebalancing times. If we stopped looking there, we'd probably feel pretty good about ourselves.

Of course, 2020 sits fresh in our minds. Semi-annual rebalancing caused an investor to miss a once-in-a-decade opportunity to buy low. By the time six months rolled around, many indexes and equities were back to their previous levels.

While the selling opportunity in the middle of 2018 wasn’t as big as the buying chance in 2020, it could have been if you weren’t living your investment life based on a calendar. We’ll also find several unnecessary rebalances along the way.

Overall, this approach is better than nothing. It can be summed up as:

Not terrible, but not optimal.

Let's flashback to the same rebalancing approach between 2008 and 2011 when the market wasn't quite as bullish, and the Fed wasn’t pumping liquidity at a breakneck pace.

While we had big moves, they were jagged and volatile. How did the calendar treat a trader back then?

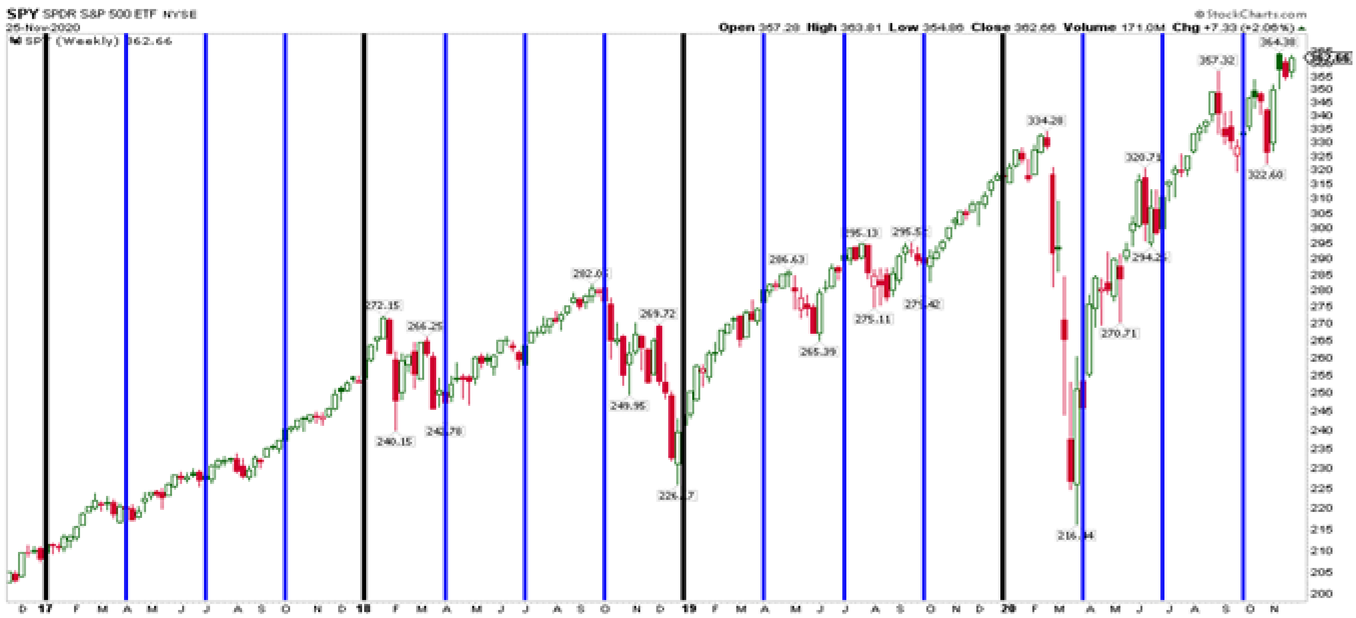
At first, all looks good as the first rebalance comes at the lows of 2008. Even though the markets continued to fall, there's nothing wrong with the initial rebalance. The problem arises at the end of 2008 and into 2009. Following a calendar had a trader rebalancing after a huge fourth-quarter rally, then missing the monstrous first-quarter decline!

In 2010, despite wide moves during the first six months of the year, rebalancing triggers based on a calendar occurred in an area where prices were virtually the same. It happened again on a smaller scale in the first half of 2010 and the second half of 2011. Those are some costly whiffs.

When we arrive at 2011, we see a big miss of the dips in the fall/winter time frame while rebalancing just for the sake of rebalancing. Missing that drop yet still rebalancing makes no sense. The only thing it accomplishes is added costs and potential tax implications. These wasted transactional cost dollars drag on results. As you can imagine, the results skew even more when you move this out to a single annual rebalance.

There are two alternative approaches I would consider. If you must use a calendar, use quarterly rebalancing based on a weekly chart. As you can see from the chart below, this method helps a trader catch the peaks and values that optimize rebalancing.

While transaction costs may be higher, those should be offset by fewer wasted transactions. There are still periods of inefficiency; however, the quarterly timing is much better.

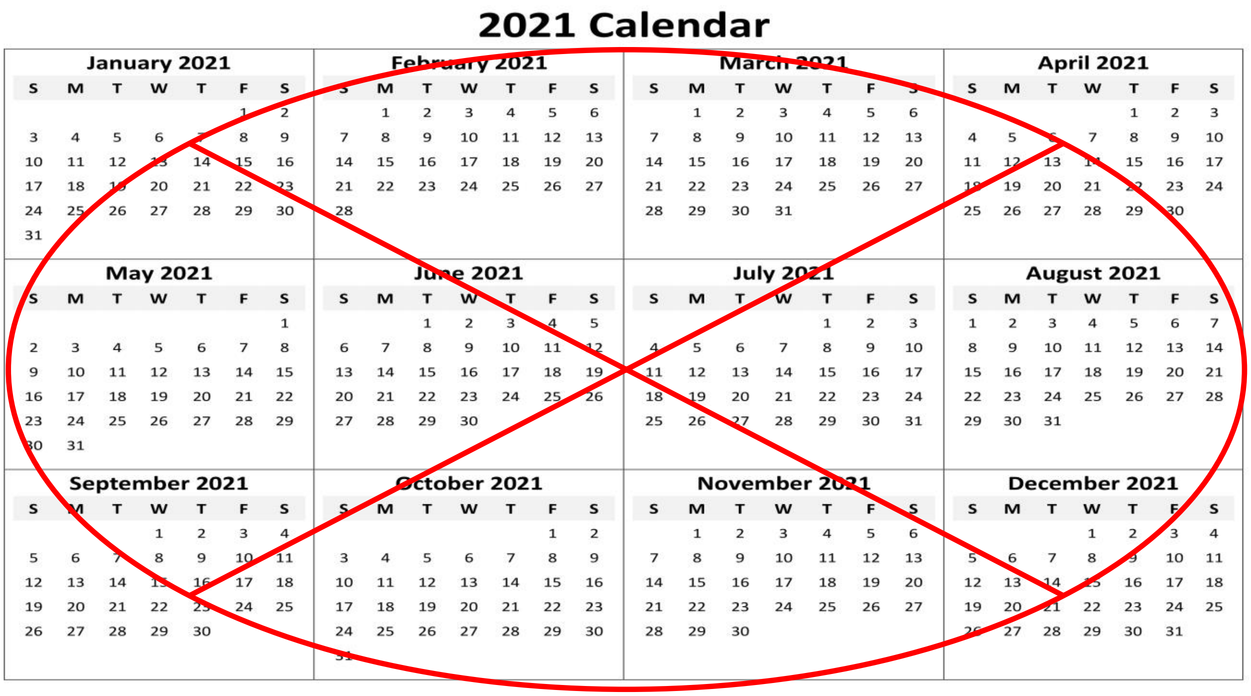


A less battle-tested but more efficient approach is called a trigger method. Triggers can be set either based directly on a securities performance or the weighting in a portfolio.

If the method is based directly on performance, then a trader might consider selling a portion of their SPY position (in this example) every time it increases 10% or buying more each time it falls 10%. We consider 10% as a minimum performance trigger on any equity-related item and increase it to 15% or even 20% for the most volatile sectors.

If using a weighting factor, then a trader would sell a portion of a position if it's weighting in a portfolio increased by 10%. Therefore, it SPY was 20% of a portfolio, then the trader would sell a portion of their SPY holding once it reached 22% of the portfolio (resetting it to 20%). Again, the percentages can vary based on the risk tolerance of the individual.

The rise of passive investing controls many portfolios, but don’t be lulled into using an archaic calendar as your guide. The turn of a page should rarely control your risk and positions. A suboptimal approach will result in suboptimal performances. Simple tools like trigger rebalancing can increase returns on index-based passive strategies anywhere from 25 to 100 basis points every year.



Start the new year right. Set aside outdated strategies to increase returns without increasing risk.