



M Wealth and Rebalancing: When, Why, and How

By Chris Dudley

Over time an individual's portfolio may drift from its original asset allocation as the distinct components vary in performance. If allowed to drift freely, the portfolio may evolve into an asset allocation that has entirely different risk and return characteristics than originally intended. Thus, the advisor faces the question of how and when to rebalance the portfolio.

In formulating rebalancing guidelines, the advisor must consider the benefits to rebalancing, as well as the costs. There are two main benefits to rebalancing: performance improvement and risk control. Performance is improved because the advisor is adding in areas that just became less expensive, and therefore, should have higher expected returns in the future. In other words, you are "selling high and buying low" as the assets fluctuate above and below their long-term expected return. There have been numerous studies examining the optimal rebalancing strategies from a return perspective with the most recent appearing in the *Journal of Financial Planning*. This study^[1] found that portfolios tended to have higher returns when there was flexibility around the allocations. In other words, an advisor will want to avoid rebalancing too frequently.

The second benefit to rebalancing – risk control – occurs as the advisor returns the portfolio to the original, intended amount of risk that catered to the client's specific needs. This is beneficial because it provides a measure of reassurance to your clients – the "sleep better at night" benefit, if you will.

At M Wealth, we strategically control the risk of the portfolios through our asset allocation process. We not only control the equity to fixed income ratio, but also the foreign to domestic ratio, emerging to foreign ratio, value tilt, and the size tilt in public equities. In addition, we are monitoring the public to private ratio and the allocation to Real Assets. Since numerous studies have shown that more than 90% of volatility is determined by the asset allocation, it makes sense to monitor and adhere to this allocation.

Unfortunately, there is no free lunch when it comes to rebalancing. There are numerous costs associated with rebalancing – the most prominent being trading costs and capital-gains taxes. Capital-gains taxes obviously only apply to taxable accounts, but trading costs and administrative costs apply to all accounts. Taxable accounts will have different rebalancing costs depending on the cost basis inside of the account. For instance, older accounts with a lower cost basis will have higher rebalancing costs.

What does this all mean, and where has M Wealth come out on the rebalancing question? At M Wealth, we are focused on the after-tax return for our clients, and thus, we try to avoid actions that cause capital gains, if possible. When it comes to rebalancing, cash is king. There are no tax costs or other costs involved in the sale of a security when cash is used, other than transactions costs.

[1] David M. Smith and William H. Desormeau, Jr., "Optimal Rebalancing Frequency for Bond/Stock Portfolios," *Journal of Financial Planning*, November 2006.

Therefore, at M Wealth we will do the following:

Elect to have mutual funds pay their dividends in cash instead of reinvested shares in order to have cash for rebalancing.

Carefully monitor cash flow in order to rebalance when there is a new cash flow into the account.
Not sell securities that have been held under one year.

Allow up to a 10% rebalancing threshold (a high-level) before selling securities. In other words, we prefer to allow a 60/40 portfolio drift to between 54% and 66% equity before we would incur capital gains in order to rebalance. This rarely, if ever, should happen as we are constantly rebalancing with cash from inflows and dividends and interest. With this flexibility, we save on expenses which add to return. In addition, studies show that even without factoring in expenses the optimal trading band is close to 10% on a performance basis.^[2]

In summary, we are constantly using cash to rebalance and adding to after-tax returns by avoiding the transaction costs and tax costs of frequently trading securities. We are constantly adding to the areas that fall below their target allocation and trying to avoid selling the areas that have appreciated above their target level.

If you have additional questions about rebalancing, please contact a member of the M Wealth team at 800-508-1820.

^[2] Smith and Desormeau.