A Simple "10% Rule" For Portfolio Rebalancing

At Guardian, we aim to keep our client portfolios appropriately diversified across different categories of investments, with weightings that take a variety of client-specific factors into consideration. While these targets are set at inception, market movements result in constant evolution, such as, a strong year in the US stock market, causing this portion of a portfolio to rise in significance. We view greater extremes as suitable junctures for portfolio rebalancing, taking gains in above-target categories, and adding the proceeds to areas below-target. The premise is simple: what does well one year often reverts backward in the next, and vice versa. Paradoxically, these are intervals when it usually feels the hardest to make these trades. It is human nature to feel content when prices are rising and anguish when they are falling. Asset mix guidelines are used for this very reason, providing guardrails to keep a portfolio from straying too far from its original design.

In reality, this does not necessitate a rapid-fire, convoluted program continually trading the markets in an expensive and tax-inefficient manner. In fact, just moving selectively, in a simple and common-sense fashion, can produce incremental gains. To illustrate the point, consider the following simple example of two portfolios. In the first, our investor splits an initial $100,000 portfolio into a 40% Canadian bond and 60% Canadian stock mix[1] on December 31st, 1993. From this point onwards, they embark on a 25-year world tour, leaving their portfolio untouched for the entire period before returning on Dec 31st, 2018. They open their year-end statement to see that their portfolio is now worth $363,000. Not bad for doing nothing!

Our second investor also takes a $100,000 portfolio on December 31st, 1993 and splits it into the same 40% bonds and 60% stocks mix. However, at the same time, they make a promise: every December 31st onwards, they will review how stocks and bonds have performed for that year. If the difference in performance between the two is 10% or more, they rebalance their portfolio back to a 40%/60% mix. That's it. A simple strategy that requires, at most, one trade per year, and does not even require a calculator. It does not consider if asset prices are rising or falling, or in what magnitude, it only cares about the difference in performance between the two categories. In the first year, bonds fall 3.1%, and stocks drop 2.5%, making for a difference of just 0.6%, so nothing is done. In the next year, bonds rise 20.5% and stocks gain 11.9%, so again nothing is done. It continues this way until the end of 2018, and as it turns out, the "10% Rule" gets triggered only 15 times over this 25-year span.

	Static	10% Rule	15% Rule
Portfolio After 5 Years	$152,856	$153,008	$152,856
Portfolio After 10 Years	$199,263	$204,667	$203,875
Portfolio After 15 Years	$239,808	$252,171	$248,261
Portfolio After 20 Years	$327,057	$352,141	$346,680
Portfolio After 25 Years	**$362,719**	**$391,768**	**$383,036**

Source: FactSet

Initially, the impact of this strategy seems fairly negligible, being just barely ahead after the first five years, and only slightly more so after the first ten years. With the passage of time, however, the gains from rebalancing compound, and our second investor ends up with a portfolio of $392,000, nicely ahead of our world-traveling investor, and a worthwhile improvement for such a low level of trading activity. The effectiveness of this simple strategy works in an even more relaxed fashion – for example, raising the trigger level to 15% sees the portfolio growing to $383,000, and only requires nine trades over this 25-year stretch.

Making portfolio rebalancing decisions often requires acting counter to market movements, selling down what is doing well and adding to what isn't. This can be a psychologically difficult endeavor at times, but as our simple "10% Rule" demonstrates, it does not have to be. In practice, a common-sense set of policy guidelines with your Guardian portfolio manager will prevent letting the market steer your asset mix and prove incremental to portfolio returns.

[1]We use the FTSE Canada All Government Bond Index as a proxy for fixed income returns, and the TSX Composite Index as a proxy for equity returns. All figures exclude tax and trading costs for simplicity.