MarketWatch

Opinion: The hidden truth about rebalancing your portfolio

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A new paper shows that moving money around increases risks

Terrence Horan/MarketWatch

CHAPEL HILL, N.C. (MarketWatch) — News flash: Rebalancing increases your portfolio's risk.

That may come as a bombshell any time of year, but especially now, as we approach the end of the year, when millions of investors are poised to rebalance their portfolios. Virtually all of them do so in the belief that they're reducing risk.

Yet, more often than not, they're wrong, according to a new study by Campbell Harvey, a finance professor at Duke University, and four co-authors from the London-based investment firm AHL-Man Group. Whenever the market is in a longer-term up or down trend, rebalancing actually increases risk, particularly downside risk.

That's because, when you rebalance, you take money away from the better-performing asset class and reinvest it in the poorer-performing one. If those two asset classes' relative strength persists after the rebalancing, as they often do, you'll end up worse off than if you had not rebalanced.

To illustrate, consider a traditional portfolio whose default allocation is 60% in stocks and 40% in bonds. At the end of last year, the stock portion represented well more than 60%, since U.S. equities gained more than 30% in 2013 while bonds fell. Therefore, any year-end rebalancing transferred money away from stocks into bonds.

Yet that has turned out to be a costly move, since stocks this year, just as in 2013, have outperformed bonds.

A similar process is present during protracted bear markets in stocks. During those declines, any rebalancing takes money away from bonds and invests more in stocks, only to have equities decline even more.

To be sure, trends don't last forever. And when they reverse, rebalancing does reduce risk. Yet, reversals of major trends are not commonplace. As a result, rebalancing's net effect is to increase risk.

This new study, therefore, puts rebalancing in a whole new light. Rather than viewing it as entirely benign and unobjectionable, it needs to be seen as a risky bet that there will be a reversal in asset classes' relative returns.

Should you take that bet?

Professor Harvey, in an interview, stressed that the answer depends on your tolerance for risk and the time horizon of your investments. If you are willing to undertake more risk and have a very long-term horizon of at least 10 to 20 years, then rebalancing is an appropriate strategy. That's because, over long periods of time, a periodically rebalanced portfolio is likely to earn enough to compensate you for its greater risk.

However, Harvey said, rebalancing becomes less appropriate to the extent you are a conservative investor and have an investment horizon shorter than 10 years.

If you are a risk-averse shorter-term investor, he added, you need to be especially aware of rebalancing's consequences. If you don't want to increase your portfolio's downside risk, you may want to avoid any rebalancing. If you nevertheless insist on doing so, Harvey said you should not mechanically rebalance at the end of every quarter or year, but instead time your rebalancings for periods when the markets' trends appear to be reversing. He directs interested readers to hispaper, which outlines one possible way of doing just that.