Opinion: Almost all retirees make this mistake

By Mark Hulbert
Published: July 27, 2019 12:23 p.m. ET

Portfolio rebalancing is universally practiced — and rarely examined

Retirees (and soon-to-be retirees) should regularly rebalance their portfolios, right?

That advice seems unobjectionable, of course. It certainly is repeated often enough.

But Humphrey Neill, the father of contrarian analysis, advised us to be skeptical of any advice that is almost universally repeated. He famously insisted: "When everyone thinks alike, everyone is likely to be wrong."

The occasion to take a second look at rebalancing was my recent Retirement Weekly column, in which I reported on the long-term performance of numerous hypothetical retirement portfolios that involve regular rebalancing. Many of those portfolios performed far worse than expected, and rebalancing was the likely culprit.

My re-examination led me to a new study that exhaustively analyzed rebalancing. It found that rebalancing improves performance only if the markets behaving in certain specific ways. And they don't always do so.

The study, "Strategic Rebalancing," was written by Campbell Harvey, a finance professor at Duke University and a consultant to Man Group, the U.K.-based investment management firm, along with three employees of that firm: Nicolas Granger and Sandy Rattray, chief investment officers, and Otto Van Hemert, head of macro research.

The traditional promise of rebalancing, of course, is that it boosts returns. By constantly selling marginal portions of assets that have outperformed, and buying more of positions that have underperformed, you in effect are buying low and selling high. In the process you also are reducing your risk.
Notice carefully, however, the implicit assumption behind these promises: An asset that has underperformed in one period is likely to perform better in the next, and vice versa — reversion to the mean, in other words. That is not always the case.

Consider the 2007-2009 financial crisis. The stock market fell for six calendar quarters in a row, with its losses getting progressively larger as the crisis unfolded. A strategy of frequent rebalancing would have magnified losses rather than reduced them. (See accompanying chart.)

Notice further that even when you’re right about reversion to the mean you can still lose money when rebalancing. You also have to get the right rebalancing frequency. If you rebalance quarterly, for example, you implicitly are assuming that one quarter’s outperformer will be the subsequent quarter’s underperformer. If you rebalance at a yearly frequency, in contrast, you’re assuming that reversion occurs at that longer frequency.

Unfortunately, there is no consistency to when reversals occur. Sometimes they occur at monthly frequency, but other times not. The same is true for quarterly and yearly time horizons.

To illustrate the inconstancy of reversal frequency, I turn to a statistic known as the correlation coefficient. It ranges from a theoretically maximum 1.0 (which is what it would be if the market’s direction in one period was always the same as its direction in the subsequent one) to a minimum of minus 1.0 (which would be the case if the market’s direction in one period was always the opposite of its direction in the subsequent one). The table below shows what I found upon calculating this coefficient over every 10-year period since 1896 for the Dow Jones Industrial Average DJIA, +0.19%:

<table>
<thead>
<tr>
<th></th>
<th>Highest 10-year trailing coefficient since 1896</th>
<th>Lowest 10-year trailing coefficient since 1896</th>
</tr>
</thead>
<tbody>
<tr>
<td>Month-to-month</td>
<td>0.19</td>
<td>-0.32</td>
</tr>
<tr>
<td>correlation</td>
<td></td>
<td></td>
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<tr>
<td>Quarter-to-quarter</td>
<td>0.27</td>
<td>-0.28</td>
</tr>
<tr>
<td>correlation</td>
<td></td>
<td></td>
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<tr>
<td>Year-to-year</td>
<td>0.76</td>
<td>-0.53</td>
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<tr>
<td>correlation</td>
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</tbody>
</table>

No wonder rebalancing doesn’t always improve performance.

Now, the researchers found that in most cases an incorrect rebalancing assumption leads to only a modest drag on portfolio performance. Where regular and frequent rebalancing really costs you is an extended bear market, such as the 2007-2009 financial crisis.

Fortunately, the researchers identify a solution: Combine rebalancing with a momentum strategy. Such a combination works because the assumptions behind a momentum strategy are the opposite of those underlying rebalancing: Momentum works to the extent that trends persist, in contrast to the trend reversals assumed by rebalancing.

You might think that it’s impossible to combine the two approaches, but the researchers came up with several ways. One, which is relatively sophisticated, allocates 10% of the money otherwise invested in a rebalancing strategy to a futures-based momentum strategy. (Interested readers are directed to their study for details of this 10% momentum/90% rebalancing strategy.)

Another rebalancing-momentum combination strategy that is more easily implemented uses a momentum signal to delay when rebalancing takes place. This is what the researchers call “strategic rebalancing.”

Otto Van Hemert, one of the study’s authors, described this approach in an interview: You simply delay any rebalancing transactions so long as the stock market is trending downward. It matters relatively little whether you define the trend by
looking at the trailing month, quarter or year; the idea is that “you sit out the negative trends” by not rebalancing. Once the trend reverses, you then rebalance.

How much benefit do you derive by following these modified rebalancing strategies? Van Hemert says that the options- or futures-based momentum-plus-rebalancing strategy reduced portfolio drawdown by an average of 5 percentage points during major bear markets. Strategic rebalancing—the strategy of using momentum to delay rebalancing—didn’t perform quite as well historically, but still reduced drawdowns by 2 to 3 percentage points.

The only bear market over the last six decades in which these modified rebalancing strategies didn’t reduce drawdowns, Van Hemert said, was the 1987 crash. That’s because it was over almost as soon as it started. That’s not been the case for most bear markets, he added, which is why these modified strategies reduced drawdowns in the other major bear markets of the last six decades.

While acknowledging that bear markets in the future could all end up being like the 1987 crash, Van Hemert said he has his doubts. That’s because, in the event of a black swan event, it is unlikely the market can “digest all the pain right away.” Far more likely is that “unimagined bad effects keep popping up.” This is what happened in the subprime mortgage crisis, Van Hemert reminded us, when its adverse consequences “rippled throughout different sectors of the economy one by one.”

And, just to repeat, to the extent future bear markets are more extended and drawn-out affairs, delaying rebalancing will markedly reduce your drawdowns.

This new research would be important to bear in mind at any time, but especially now if you think there’s an above-average chance of an imminent major bear market. If so, then it would especially behoove you to put in place now a modified rebalancing strategy.

Mark Hulbert is a regular contributor to MarketWatch. His Hulbert Ratings tracks investment newsletters that pay a flat fee to be audited. Hulbert can be reached at mark@hulbertratings.com

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