Did COVID-19 Force You to Wrongly Rebalance?

Your investment advisor can help you overcome your biases and worries

There is no question that COVID-19 has caused untold damage to your retirement plan. Whether you are a few years away from beginning to draw down your retirement funds or decades away, the pandemic brought us a couple of market corrections, a bear market, a few bear market rallies, and speculation as to when the next bull market might begin.

But how many people looked at their quarterly statements at the end of March this year and decided to sell out of equities and go to cash? Well, for those that did, here is what they missed:

- When the second quarter of 2020 closes (the time period from April 1st through June 30th), the S&P 500 and the Dow Jones Industrial Average are both on track to turn in their best quarterly performance in over 10 years.

Investors that sold out of equities back at the end of the first quarter might have been telling themselves that they were “rebalancing.” But they weren’t. They were panic-selling. Rebalancing is a very different concept.

Rebalancing Matters

Rebalancing is an exercise that involves selling the investments that have appreciated and buying the assets that have gone down in order to bring your allocations back in line with your original portfolio design. Rebalancing is not quite as simple as it sounds though – it’s as much a science as it is an art.

In golf terms, understanding the science is akin to understanding the physics of why a spinning ball hooks or slices. The art is the execution of the science, such as when you are actually playing golf. It is the execution and follow-through that produces the desired outcome.

Knowing that rebalancing boosts returns is useless unless you – the investor – have the time, discipline and nerve to follow through and actually strike the ball.

An Investment Advisor Can Help Rebalance

Rebalancing is the most helpful when it is most difficult. Again, the exercise involves selling the investments that have appreciated and buying the assets that have recently gone down.

Remember when the S&P 500 bottomed out for the year on March 23rd? How many investors were disciplined to buy more U.S. equities at the end of the first quarter? The truth is that people are biased to believe that recent occurrences will continue. When it comes to the markets, this instinct must be overcome.

This is one area where an investment advisor can add tremendous value. Even an advisor who does nothing other than help you set an asset allocation and then

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rebalance once a year might boost your returns over a buy and hold strategy. This rebalancing can also lower the volatility of your portfolio. Together, these bonuses help increase the likelihood that you will reach your retirement goals.

Yes, you could do this yourself, but many investors don’t. A few investors buy and hold investments while an even greater number chase returns, moving in the exact wrong direction. Even an advisor who only keeps you from chasing past performance might significantly boost your returns.

If you choose to rebalance yourself, you can accomplish this most easily by automating your rebalancing. Automatic rebalancing is most common in 401(k) accounts. If your account offers the feature, take advantage of it. If you must choose specific months or days to rebalance, consider quarter-ends.

The important thing is to make sure your portfolio is regularly rebalanced. If the only available rebalancing method is manual, the danger is that you will emotionally pick the point to rebalance which will be the exact wrong time. Instead, you should pick times of the year blindly and then stick with it.

That said, receiving the rebalancing bonus requires that investors have an asset allocation plan in the first place. Most do not.

Asset Allocation & Rebalancing

Your asset allocation definition matters. Rebalancing works best with non-correlated asset categories, like emerging market stocks and U.S. stocks. If you define your asset classes incorrectly, rebalancing between them may not help.

You should not define your asset class as one industry of the economy. One industry could lose value indefinitely as another industry rises to take its place. Rebalancing into a failing industry only brings your returns down with it.

Meanwhile, you dodge this problem with broader asset class definitions. Information technology, basic materials, and consumer staples are good, broad definitions while candle-makers, diamonds and leather jackets are too narrowly defined and will fail you.

Further, some sectors are not on the efficient frontier, which identifies portfolios that achieve the highest return and the lowest volatility. Including them in your asset allocation is simply the wrong move. Rebalancing to a poorly designed asset allocation often means moving money from categories that are on or near the efficient frontier into inefficient investments, hurting returns.

Expenses & Taxes Matter Too

There is a great deal to be said about the method of rebalancing. Keeping transaction costs and capital gains taxes low when rebalancing also helps boost your return.

Funds with high expense ratios put a drag on returns too. Even an index fund drops off the efficient frontier when the expense ratio becomes excessive. And it goes without saying but rebalancing into bad mutual funds also hurts your returns.

While the science and art of setting an asset allocation and regularly rebalancing back to it is not an easy discipline, it will help.

Your financial advisor can teach you the art and the science – and then do both for you.

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