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Fureyous: How often should we rebalance portfolios?

Michael Furey | Delta Research & Advisory | 03 June 2014

It appears that the financial planning industry is a big believer in rebalancing – but a little unsure as to how often is optimal. Some accept the automatic quarterly rebalance option, some rebalance at the client review time, some do it annually, others at 13 months to potentially reduce capital gains tax by taking advantage of the 50% CGT discount.

Because the rebalance decision is often made without a second thought, portfolio construction practitioners may forget that it is, in fact, an active decision as to the likely frequency of tops and bottoms for the markets into which they are investing their clients funds. For example, if I choose quarterly rebalancing for my client, in effect, it is the same as believing it is likely to be a good decision to sell some equities in three months if they have gone up compared to other asset classes, or buy some more if they underperformed. This assumption may clearly be wrong and may also have little in common with the asset allocation decision that is typically designed with a much longer period in mind. In other words, the asset allocation decision is a recommendation of the most efficient asset allocation for a specified time period – and that time period is more likely to be multiple years than just one quarter. By rebalancing every quarter, I risk diluting the designed benefit of my asset allocation decision which is made with different goals in mind.

Using just Australian bonds and Australian equities, I undertook a little experiment to find out which rebalance frequency may produce the better results. My experiment started with a 50% allocation to Australian Bonds and 50% to Australian equities and I rebalanced at various intervals starting from December 1976 (that's how far back my data goes). For the purposes of simplicity, I ignored tax and transactions costs (very important considerations with real money). The results are shown in Figure 1.

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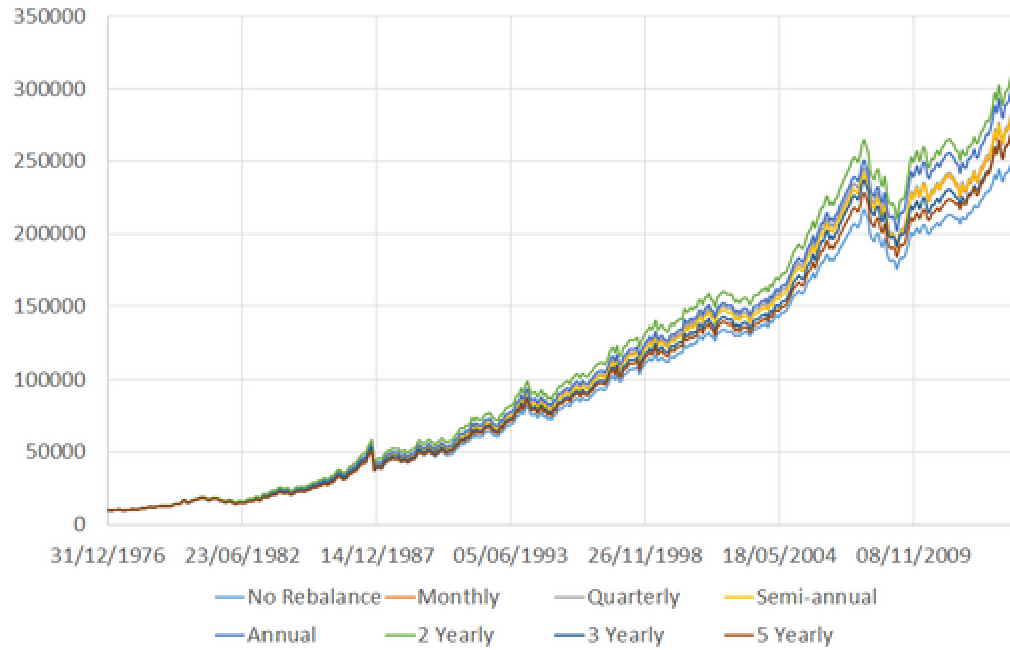
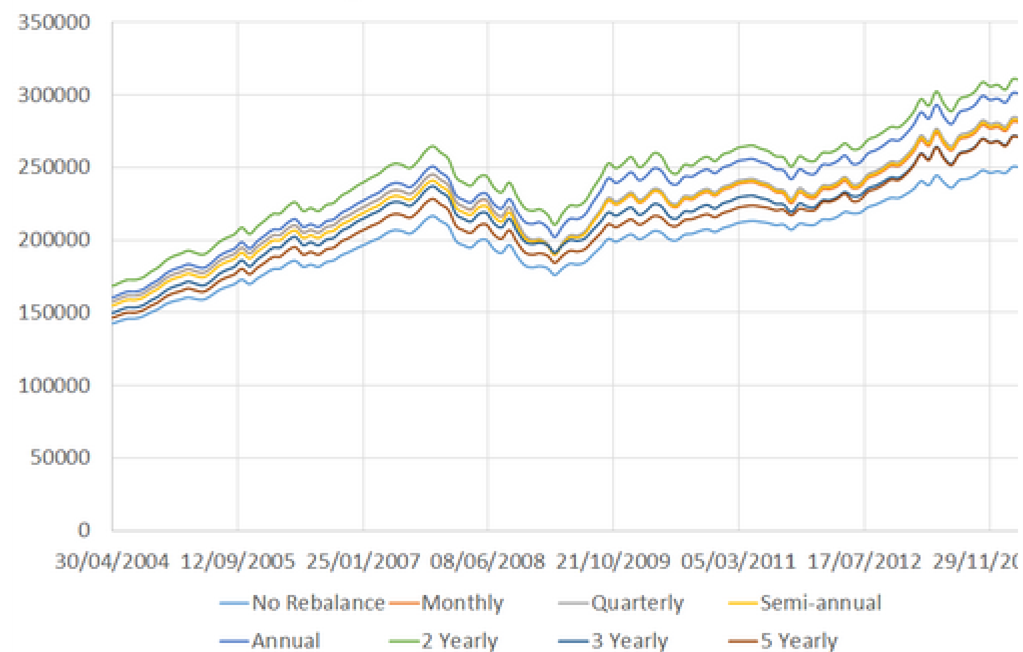
Figure 1: Rebalancing between Australian Shares and Bonds – 50/50



Source: Delta Research & Advisory

It is obviously a fairly close race over almost 40 years so Figure 2 provides a close-up that more clearly shows the winner.

Figure 2: Rebalancing between Australian Chares and Bonds – 50/50



Source: Delta Research & Advisory

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... and the winner is... the two yearly rebalance option. Second place goes to the annual rebalance option. Last place goes to the "no rebalance" option.

Now, it's important to point out that these results are far from complete. Why? Because that start date is always 31/12/1976 and the end date is always 30/4/2014 – therefore for some rebalancing options there are some dates (like yearly anniversaries) that are always rebalanced on, while other months (e.g. for quarterly rebalancing – Jan, Feb, Apr, May, July, Aug, Oct, and Nov) which never experience a rebalance. So, for completion to this experiment different start dates, and rebalance months should be used. As alluded to above, while the rebalance decision is a passive decision, essentially it is still making a call that it is worth selling one asset and buying another at particular points in time.

These early results are interesting. A two-year rebalance can provide other guaranteed and obvious benefits over monthly, quarterly, six monthly, and annual rebalancing. i.e. lower tax consequences and lower transaction costs.

Finally, there is no over pattern at this point in time. Given the worst results were for the less frequent "no rebalance" and five-year rebalancing options, and the best beat more frequent rebalancing options, perhaps the findings suggest that stronger performing equity markets are more likely to behave on a two-year cycle. To be honest, I'm not sure yet.

While the early results show that two years may be best rebalance period, don't take this for granted – and please look out for a completed experiment in weeks to come.

Finally, I have to admit that I got a little lazy and failed to do any literature search for others who may have written on the rebalancing subject. Still, I hope the early results of this experiment using Australian data adds some value to the debate.

Michael Furey is Managing Director of Delta Research & Advisory, which specialises in providing independent, conflict-free investment research and asset consulting services to dealer groups (AFSLs), financial planners, and self-directed investors. He has worked in the financial planning industry since 1999, both in research and financial planning roles.