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A Better Way to Think About Portfolio Rebalancing

Investors should regularly adjust their investments, but not the way they usually do it

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Rebalancing is a mantra of investing—the idea that investors should regularly adjust their portfolios to keep a fixed proportion of stocks and bonds, based on their tolerance for risk.

I agree that rebalancing should be a mantra. But I disagree with the way most investors practice it.

The problem is that the traditional approach to rebalancing pays too much attention to a misguided definition of risk, and too little attention to what investors actually want and save money for. What's more, it leads to excessive trading of stocks and bonds—which is unnecessarily costly.

To understand why, consider first how rebalancing typically works. Investors gauge their appetite for risk—that is, the volatility of a portfolio. The more stocks in a portfolio, the higher the long-term returns, as well as the higher the volatility. Investors then choose a balance of stocks and bonds that gives them the returns they desire combined with the volatility they can sleep with—say 60% in stocks and 40% in bonds. If, over the next few months, stock prices increase while bond prices remain the same, so that the portfolio is 70% in stocks and 30% in bonds, they would sell stocks and buy bonds until the 60-40 proportions are restored.

Such rebalancing is executed regularly, usually quarterly or annually, as stock and bond prices go up and down.

Aiming to satisfy wants

But there's another way of looking at this. According to behavioral finance, investors want to satisfy wants. I like to say, with obvious exaggeration, that each of us wants two things in life. One is not to be poor. The other is to be rich. Not being poor means, for example, having an adequate level of retirement income. Being rich means, for example, being able to pay off a child's college debt or donate money to charities. Under this theory, risk isn't measured by the volatility of a portfolio, but rather by a failure to satisfy these wants. Sometimes, it could result in the same portfolio, but often it doesn't. To use a simple example: Investing a portfolio in a money-market fund ensures low volatility, but it's hardly a low-risk portfolio, since it almost certainly guarantees that it will fail to satisfy even the minimum wants.

To see how rebalancing works under a wants-based approach, consider an investor whose primary want is to be rich, and her secondary want is not to be poor. If that's the case, the investor figures she can satisfy the not-poor want with a small amount of bonds (plus her income), so her portfolio is composed of a thin portfolio layer, 20%, in bonds, and a fat portfolio layer, 80%, in stocks.

Next, suppose that during the following month stock prices increase while bond prices remain the same, such that now her portfolio consists of 90% stocks and 10% bonds. Under the standard rebalancing approach, an investor would sell stocks and buy bonds. But that isn't necessarily the case with wants-based rebalancing. If the investor still thinks her not-poor wants can be satisfied with the bonds she currently owns plus her earnings potential, then she shouldn't rebalance at all.

I recall reading of a woman who died and left behind millions in stock, and dedicated most of it for helping the poor. Almost all her portfolio was clearly devoted to being rich, so she could benefit others. Looking at her portfolio without the accompanying story we might have concluded that the woman was motivated by high risk tolerance. But wants for riches to benefit others motivated her, not high risk tolerance.

A retiree's objective

Let's look at another example, of an older retired person whose main objective is not being poor, leading to a portfolio that is 80% bonds.

Now suppose that during the following month stock prices increase while bond prices remain the same, such that now his portfolio consists of 30% in stocks and 70% in bonds. Traditional rebalancing calls for selling stocks and buying bonds. In this case, though, if he deems the not-being-poor layer of his portfolio sufficient, he need not rebalance, enjoying a better shot at being rich.

A financial adviser told me about a client, a woman who managed to save enough money to retire at age 60. Her savings ethos derived from a poor childhood. She was always afraid that she would end up living in a box eating cat food. Despite more than enough money to sustain her lifestyle for the rest of her life, roughly 70% of her portfolio is in bonds. Her personal statement was "By nature, I'm risk-averse."

That woman speaks in the language of risk, but she is thinking in the language of wants. Her want to not be poor—not live in a box and eat cat food—motivates her to keep a fat not-being-poor portfolio layer in bonds.

Why does it matter if an investor speaks the language of wants rather than the language of risk? Potentially, a lot. Persuading that woman in the language of risk that she should not be so very risk-averse is hard when she perceives risk-aversion as part of her nature. It might be easier to persuade her in the language of wants and perhaps a spreadsheet that she can satisfy her wants for not being poor with a portfolio containing much less than 70% in bonds.

Speaking the language of wants is also beneficial when investors declare, as many did in early 2009, that they can no longer take the risk of stocks that have fallen so steeply. An adviser speaking the language of wants might forestall hasty dumping of stocks by pointing that while losses are always painful, that investor still has more than enough in bonds and stocks to forestall poverty.

Missed opportunities

Two rationales are commonly offered for the traditional fixed-proportions rebalancing method. First, investors who choose a particular fixed proportion for their portfolio have in effect declared that their chosen proportion reflects their optimal trade-off between portfolio returns and the volatility of returns.

But, again, risk isn't about volatility; it's about not satisfying wants. Remember that money-market fund? What could be riskier than that, if what you want is to have a decent retirement?

The second rationale centers on the claim that returns are mean-reverting—that is, above-average stock or bond returns are predictably followed by below-average returns. If so, fixed-proportions rebalancing entails selling stocks or bonds at above-average prices and buying them at below-average prices.

But stock and bond returns don't follow predictable patterns. Yes, fixed-proportions rebalancing would have helped in 2007 as it directed us to sell stocks and buy bonds, and it would have helped again in early 2009, directing us to buy stocks and sell bonds, knowing now that stock prices subsequently increased. But fixed-proportions rebalancing might have also directed us to sell stocks at many points since 2009. That would have been a costly mistake in a bull market that is now more than nine years old.

What's more, fixed-proportions rebalancing imposes extra costs in taxable portions of portfolios. Realizing losses reduces taxes, but rebalancing is likely to involve realizing gains as we sell stocks or bonds following increases in their prices. Fixed-proportions rebalancing also imposes greater transaction costs than wants-based rebalancing because it is executed more frequently. After all, rebalancing with wants-based investing is executed infrequently, typically as a person goes through life's changes and wants change. Years might pass between one rebalance and a following one.