The Week

WACHOVIA SECURITIES

May 26, 2009 **Tom McManus, Chief Investment Officer**

Periodic Rebalancing of Your Portfolio Can Add Value over Time

- In previous editions of "the Week" (January 12 and January 20, 2009), we illustrated the theoretical performance investors might have achieved if they had been fully invested in stocks — or in long-term Treasury bonds — since 1925. We have also shown how various combinations of these assets, say, 50% stocks and 50% bonds or 70%/30%, might have performed, too.

- Our calculations of historical performance assume the mixed portfolios were rebalanced annually — by reducing exposure to assets that have performed in a way that results in a higher weighting than originally specified. The proceeds of any sales are applied to assets that have fallen below their specified weighting — so the rebalanced portfolio reflects the original intent.

- At its core, portfolio rebalancing is a "value strategy," because the investor increases exposure to underperforming asset classes after a decline, and reduces exposure to outperforming asset classes after an advance. Like any value strategy, rebalancing takes discipline. Looking backwards at 2008, you may wish your portfolio had been invested primarily in Treasury bonds and entirely free of equity exposure. But looking forward, a rebalancing strategy requires you to consider trimming your bond exposure and placing the proceeds into stocks.

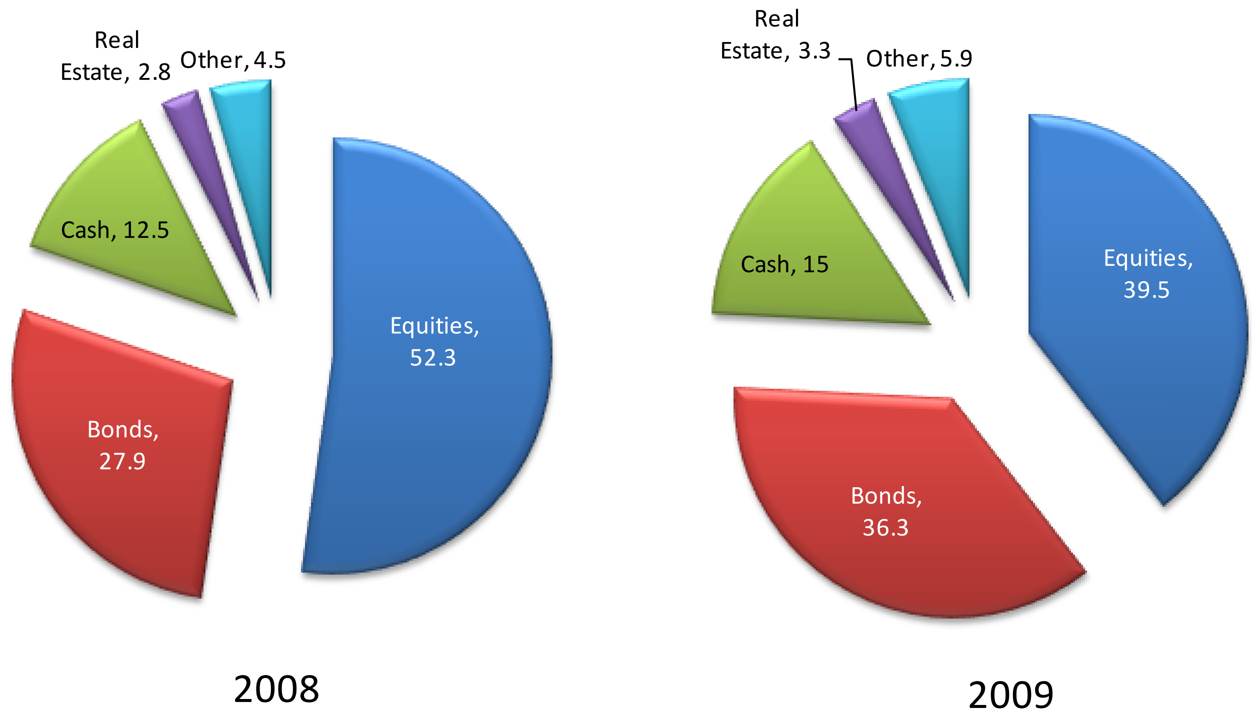
- It is easier to adhere to a rebalancing strategy if you are confident that short-term anomalies between the performance of major asset classes will be corrected, eventually to revert to an underlying, long-term equilibrium. Developing and maintaining this confidence is easier as it relates to stocks and bonds — and many of the other major asset classes included in our Capital Market Assumptions (an executive summary was published last week) — than it is for individual securities. Essentially, an investor rebalancing a portfolio is "averaging down," a tactic that we do not recommend for the typical investor at the individual security level.

- All portfolios — whether they are actively- or passively-managed, require some maintenance. The stocks comprising an index are always subject to change, and bonds either mature or are sometimes downgraded. But apart from the portfolio maintenance required to meet or hopefully beat the benchmark, it should be easy to see that an all-stock or all-bond portfolio is somewhat simpler than a diversified one.

- Diversified portfolios are usually designed to match investor preferences regarding expected risk and potential return. The examples we showed in prior issues were based on simple combinations of just two assets, large capitalization domestic equities and long-term US Treasury bonds. We showed how the 50%/50% portfolio had performed over time, and how the disparity between the performances of these two asset classes was at a record. Stocks were far below their own long-term trend, while the bonds were significantly above trend.

- As our January 12 edition (entitled "Bearish BARRON'S Roundtable is Probably a Bullish Sign") explained: "Today, we design diversified portfolios with 10-15 assets or more, but the basic theory is the same. Over time, investors have learned one lesson well: portfolio rebalancing usually proved helpful."

100 Largest Managers' Asset Allocation Was Shifted Dramatically By Market Events: Time to Rebalance?



Note: Aggregate asset mix of 100 largest money managers (excluding Capital Group) as determined by an annual survey. Source: Pensions & Investments.

Our chart shows that the aggregate asset mix of the 100 largest money managers was shifted dramatically — by market events and investor preferences — in 2008. Equities fell by nearly −13 percentage points, to about 40% of the total portfolio. Each of the other 4 categories saw an increase in their relative weighting, with bonds gaining the most (+8.4%). The financial crisis, recession and bear market punished risk-takers and rewarded defensive allocations, which became increasingly popular throughout the year and into the start of 2009.

The rally in the stock market since early March has coincided with an increase in investors' risk appetite. Bonds of companies with weak credit have recovered some of their steep drop, while the least risky bonds — high quality corporate and Treasurys — have either not participated in the rally or actually suffered a decline in value.

The firms managing the large pools of investment capital represented in our chart are not solely responsible for resetting the weightings represented by the pie slices. But some — like ourselves — are advocating that their clients rebalance their portfolios to reflect their longer-term preferences regarding risk and return.

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