

Dubious benefits from portfolio rebalancing

COMMENT: Financial planners may enjoy the process more than their clients

Mr A and his new wife have decided to retire early and live off their investments. At a meeting with their financial adviser, he tells them that this is no problem and that for an all-up annual fee of 3 per cent of their assets, his mastertrust-based investment platform will let them forget about investment matters so they can concentrate on spending that cash pile together.

Their certified financial planner explains that one of the keys to wealth and happiness is to hold a diversified portfolio which is regularly and automatically rebalanced back to the originally agreed asset allocation - in this case, 30 per cent bonds, 70 per cent international shares.

This sounds sensible to Mr A and, anyway, he is late for golf. He signs and dates the cheque for \$500,000. It is January 10, 2000.

Three short years later, world sharemarkets are slumping and Mr A is a worried man. He sits down to read his latest portfolio review.

He is horrified to see that not only is his portfolio now worth only \$350,000 but each quarter the automatic rebalancing has been selling the only good thing in the portfolio, bonds, and buying more international shares, which only seem to go down.

Mr A rings his financial planner, who cheerfully tells him not to worry as he is buying low and selling high.



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"Rebalancing permits financial planners to justify their monitoring fees."

Mr A, certain that the man is mad, fires him and wonders how his wife is going to take the news that the regular winter-long Gold Coast holiday has been downsized to a week in Rotorua.

Rebalancing portfolios is big business in New Zealand. It permits financial planners to justify their monitoring fees and it keeps lots of stock brokers and bond dealers busy.

But is it good for mum and dad?

Not all financial planners advocate rebalancing but, as a low-cost and scalable business strategy, it has some appeal.

It provides tangible evidence that the client is getting something for

his/her monitoring fee and, once the initial weightings have been determined, it can just be a routine, often computerised, series of buys and sells each quarter.

Advocates of the fire and forget type of automatic rebalancing common in the mastertrust world argue that by investing a set proportion of your assets in a fund and trimming back the profits each time it pushes up, you lock in profits which are available to buy back when the market falls.

But this sort of simplistic strategy also works in reverse - when things go bad, you buy more of them, which could get pretty painful if the market went down for 20 years.

Mr A was originally happy to have a base of \$150,000 in bonds and to take a bit of risk with the other \$350,000. He spat the dummy three years later because his bond holding, thanks to the computer, was now down to \$119,223.

What automatic rebalancing doesn't always acknowledge is that risk appetites often change with the level of the Dow Jones index and, while computerised rebalancing achieves economies of scale for financial planners, there is no way it can replace knowing your client.

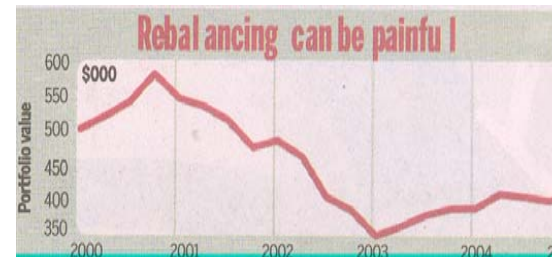
In any case, it's debatable whether rebalancing confers much in the way of benefit to clients.

All the studies of behavioural finance and investment psychology suggest that one of mum and dad



MISINFORMATION: Advice on portfolio management is about as reliable as Iraq war propaganda.

PICTURE / REUTERS



investors' biggest enemies is holding on to losers far too long and selling their winners too early.

Automatic rebalancing is all about selling what goes up and buying what goes down. Furthermore, by blindly buying what goes down, are we not thumbing our nose at the efficient market: perhaps international shares went down in the 2000-2003 period for good reason - they were overpriced to start with, maybe?

Then there is the cost element itself, probably the subject of more misinformation than the war in Iraq,

wheels of finance must be lubricated by brokerage, stamp duty and the buy/sell spread, to name but a few actual costs.

In Britain, the leading regulatory body, the Financial Services Authority (FSA), calculates that a buy and a sell by an institution on the London Stock Exchange costs about 1.8 per cent.

A large part of that expense is in the form of the "bid/offer spread", the difference between the price you get when you sell a share - or any other investment - and the higher price you pay when you are buying.

Switching from global equities to New Zealand bonds takes on an entirely different perspective if one realises that it will cost one-quarter of a year's return. The interesting thing about these costs is that, as the fund managers' marketing material tells us, they can get bulk discounts on the brokerage and custodial side of things, but what they don't say is that it frequently costs more to deal in

larger volumes in terms of the bid/offer spread and market impact.

The right approach to rebalancing probably depends on the individual.

Certainly one's enthusiasm is likely to be tempered if one knows how much it actually costs.

In practice, many retired investors are happy, once they have amassed a reasonable sum in bonds, to let their diversified property and equity portfolios compound away without too much costly intervention.

For others, rebalancing can be done far more cheaply when they have new funds to invest or need cash for a new car.

This type of active rebalancing, however, has a downside as it requires input from your financial planner and can't be delegated to a computer.

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