CIBC ASSET MANAGEMENT

GUIDE TO PORTFOLIO CONSTRUCTION

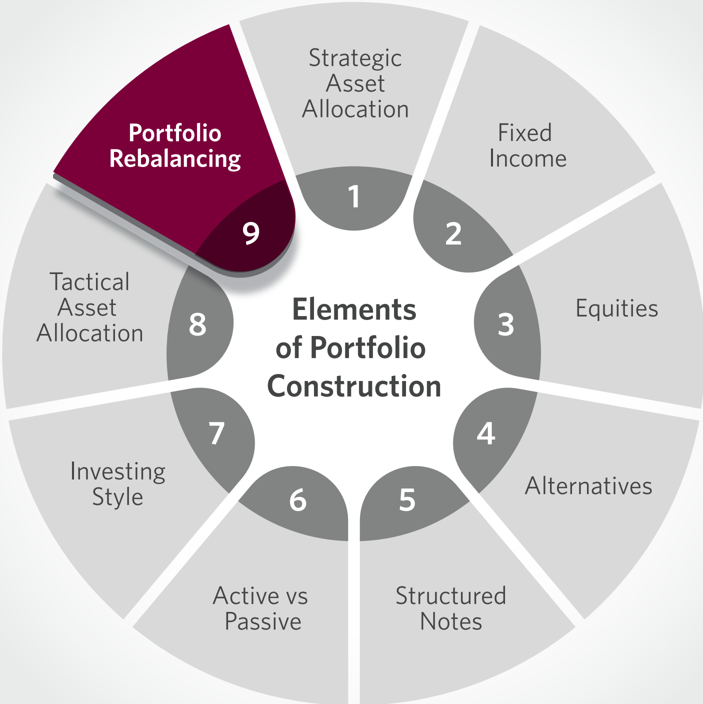
Portfolio Rebalancing

Guide to portfolio construction

Market and economic uncertainty, combined with relatively low expected returns for many asset classes, are making it harder for individuals and institutions to reach their financial goals. A thoughtfully designed portfolio that helps you embrace market opportunities while preparing for the unexpected has never been more important.

There are several components of a well-constructed portfolio, including a robust strategic asset allocation that's consistent with your long-term goals and objectives. A mix of asset classes such as equities, fixed income and alternatives, and strategies such as tactical asset allocation, active versus passive investing, and portfolio rebalancing all have a role to play.

This guide highlights how portfolio rebalancing can help improve portfolio performance and help you achieve your ambitions.



Portfolio Rebalancing—maintaining your portfolio's edge

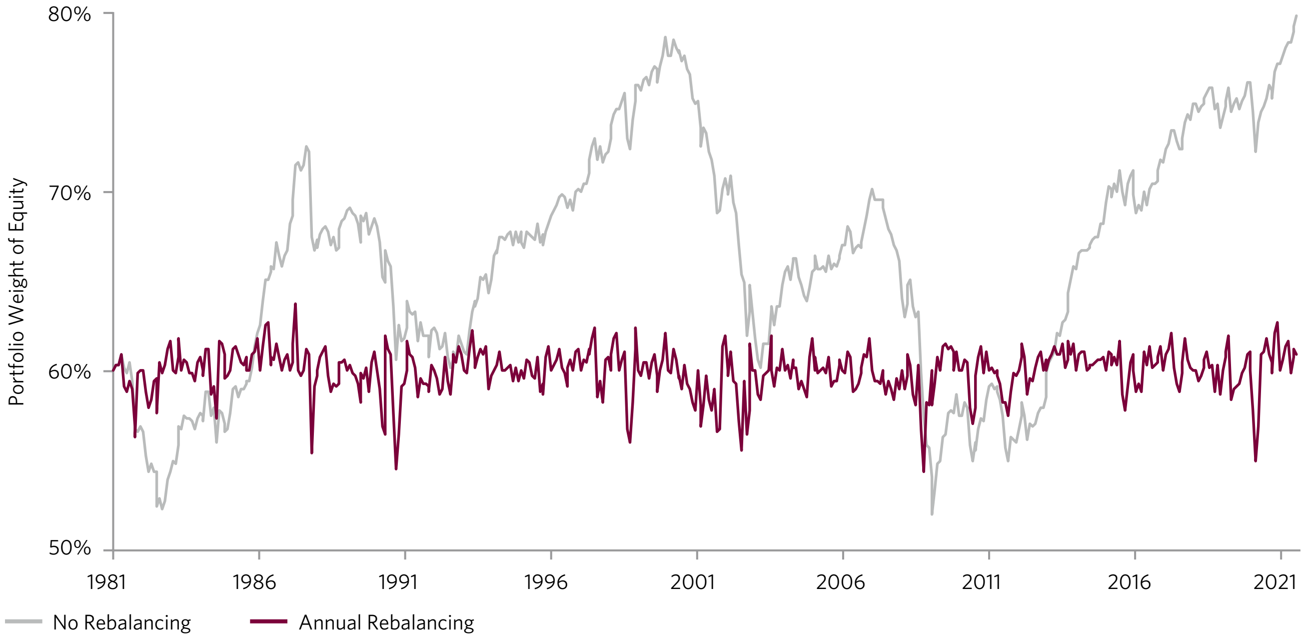
Earlier chapters in this series discussed the elements of a well-constructed investment portfolio. The basic building block is Strategic Asset Allocation (SAA). This has a long-term focus, and ensures that the mix of asset classes included in an investor's portfolio maximizes the opportunity to achieve long-term investment goals in a manner consistent with identified risk tolerance. Once in place, it is important to regularly review the SAA to ensure that investment goals, risk tolerance and strategic allocation remain aligned.

Tactical asset allocation (TAA) aims to provide an additional source of return to an investor's portfolio, over and above the expected return that arises from SAA. This additional expected return is achieved by adjusting the strategic asset weights within a range established by investment policy guidelines. It is guided by rigorous analysis of current and expected market and economic conditions and generally looks to capitalize on shorter-term market opportunities.

The final component of a well-constructed portfolio is disciplined rebalancing. The need to periodically rebalance investment portfolios primarily arises from market developments. Asset prices change through time, both in absolute terms and relative to one another—some markets go up, or down, more than others during a particular period. These price changes can move portfolios away from their strategic asset allocation weights; the weight of outperforming assets increases and the weight of underperforming assets declines (Figure 1). This drift may provide a passive performance benefit to investors in terms of some additional return in the short term. But it also introduces additional, unintended risks into portfolios. These include additional benchmark tracking error, as well as higher risk concentrations implied by a growing allocation to one or another asset class, and higher portfolio volatility during periods of equity outperformance (Figure 2).

Rebalancing is a disciplined way to maintain risk and diversification within an acceptable range.

Figure 1 – Impact of Rebalancing on Portfolio Equity Weight



Source: The information was prepared by CIBC Asset Management Inc. using the following third party service providers' data: Bloomberg LP. Sample: January 1981 – August 2021. Monthly data. Data calculated assuming an initial 60/40 equity / fixed income portfolio. Equity: MSCI World Total Return Index; Fixed Income: Bloomberg U.S. Treasury Intermediate Total Return Index.

Figure 2 – 3-year Rolling Portfolio Volatility

Source: The information was prepared by CIBC Asset Management Inc. using the following third party service providers' data: Bloomberg LP. Sample: January 1981 – August 2021. Monthly data. Data calculated assuming an initial 60/40 equity / fixed income portfolio. Equity: MSCI World Total Return Index; Fixed Income: Bloomberg U.S. Treasury Intermediate Total Return Index.

Rebalancing implies periodically selling assets that have recently outperformed and buying assets that have underperformed. This strategy is consistent with two attributes of asset class returns: momentum and value.

- Over shorter-term periods, returns often exhibit momentum. This is the tendency for a positive return in one month to be followed by another positive return in the next month. In the same way, a negative return often tends to be followed by another negative return.
- Over the long term, asset class returns tend to reflect their intrinsic value[1]. When asset valuations stray too far away from intrinsic valuations, the likelihood of mean-reversion increases.

The presence of both momentum and value tendencies means that asset classes that have out- or under-performed in the recent past—due to momentum—will tend to revert to their longer-term trend value over time[2]. Regular rebalancing capitalizes on these two tendencies.

[1] This is determined by the present value of expected cashflows.

[2] Note that this does not mean that prices of relatively expensive assets have to actually decline. Instead, this reversion to value can be achieved through relative underperformance.

The rebalancing schedule

In any period, we never know precisely how far prices will drift from their underlying intrinsic valuation, making it impossible to create an optimal and precise rebalancing schedule. Instead, investors typically follow one of four approaches to rebalancing.

1. **Regular calendar basis**—quarterly or annual rebalancing, for example. One downside with this approach is that the extent of drift during a period may be small, leading the investor to incur unnecessary transaction costs. The scheduled timing of calendar-based rebalancing may also coincide with a period of market stress and incur relatively high transaction costs associated with illiquidity.
2. **Threshold basis**—rebalancing whenever asset class allocations drift away from strategic weights by more than a predefined percentage. For instance, when the equity weighting in a traditional 60/40 portfolio (i.e. 60% equity, 40% fixed income) moves outside of a 55-65% range, rebalancing guidelines could trigger a portfolio rebalancing. Some measure of portfolio tracking error can also be used as the threshold in this approach.
3. **Partial rebalancing**—either calendar or threshold-based. In this case, only part of the drift in asset allocation would be adjusted at each rebalancing. We do not recommend this approach because it risks compromising the separation of strategic and active decision-making within a portfolio.
4. **Purely arbitrary** and left to discretionary judgement. We also do not recommend this approach because it relies on a subjective evaluation of price levels and market conditions.

All these approaches involve trade-offs. There are higher transaction costs for more frequent rebalancing but more portfolio asset drift and higher unintended risks with less frequent rebalancing.

Let's look at a 60/40 equity/bond portfolio under three rebalancing profiles: no rebalancing, quarterly calendar rebalancing and annual calendar rebalancing (Figure 3). As expected, using four decades of historical data, the volatility of the rebalanced portfolios is lower than the portfolio that was not rebalanced. The length and depth of the historical cumulative maximum drawdown are also smaller. As discussed above, this reduction in portfolio risk is the primary expected benefit of rebalancing.

Figure 3 – Portfolio risk statistics

Risk/Return	Rebalancing		
	None	Quarterly	Annual
Annualized Risk, %	8.72%	7.85%	7.84%
Information Ratio	0.95	1.04	1.04
Maximum Drawdown, %	-30.65%	-24.75%	-24.42%
Length of Maximum Drawdown, months	81	73	73

Source: The information was prepared by CIBC Asset Management Inc. using the following third party service providers' data: Bloomberg LP. Sample: January 1981 – August 2021. Monthly data. Data calculated assuming an initial 60/40 equity / fixed income portfolio. Equity: MSCI World Total Return Index; Fixed Income: Bloomberg U.S. Treasury Intermediate Total Return Index. Length of Maximum Drawdown: the longest time it takes cumulative returns to reach a new peak following a period of capital loss.

Rebalancing flexibility

Incorporating some flexibility into rebalancing schedules makes sense. During periods of market stress (i.e. the February-March 2020 period) liquidity becomes scarce and transaction costs rise. Trying to rebalance according to a rigid schedule at the height of these periods is unlikely to produce optimal results.

But flexibility in a rebalancing schedule is not the same as rebalancing on an ad hoc basis in an effort to time markets. Ad hoc rebalancing is an active investment decision—in a well-constructed portfolio, strategic and active decisions are kept separate.

If an investor has high conviction about a prevailing trend or market direction, a tactical risk budget can be created and spent to implement that view. This will also allow the portfolio to adhere to its predetermined strategic allocations and guidelines. Confusing strategic and active decision-making also increases the difficulty of establishing a coherent performance attribution.

Key portfolio rebalancing considerations:

- The need for portfolio rebalancing arises from market developments. Disciplined portfolio rebalancing helps ensure a portfolio's risk and diversification is kept within an acceptable range.
- Regular portfolio rebalancing capitalizes on both momentum and value tendencies within asset classes.

Let's partner on your portfolio construction

Changing market conditions don't change your goals, whether it's saving for a home, a child's education or investing for retirement. Careful portfolio construction that helps you embrace market opportunities while preparing for the unexpected has never been more important.

Your CIBC advisor can help you develop a targeted investment approach using the multi-asset solutions that work best for you.

Contact us today to tailor your portfolio and help you get where you want to be.

To learn more, contact your CIBC advisor.

All information in this document is as of August 31, 2021 unless otherwise indicated and is subject to change.

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