

Rebalance Your Way To Better Investment Performance

By Eng Tiang Chuan

Is it too early to sound the death knell for long term investments? Can we recover if we lost 10 years of growth in a single bear market? We offer proof that rebalancing can help.

The collective tumble of the various equity market and asset classes in 2008 has prompted many to sound the death knell for long term investments and diversification. What kind of value does the buy-and-hold investment approach and diversification add when investors find their investments losing 10 years of growth in a single bear market and asset classes from equities to commodities falling in tandem, one might argue. We offer some anecdotal proof of benefits of diversification and long term investing and how Rebalancing can help in the investor's portfolio.

Amidst the growing skepticism on traditional investment principles following the perfect storm in the financial markets came voices that support various market timing strategies. Tactics from day trading to market cycle investing have been touted as the panacea for investment returns. While these approaches might work with a perfect 20/20 hindsight, it is not so straight forward implementing for an unknown future. The average investor may lack the discipline and insight to successfully carry out the stratagem. How-



ever, due to the Behavioral Finance trail of Over-Confidence, not many investors would think they are 'just' average. For instance, if you drive, do you think you are an average or above average driver?

The latest research by US-based market researcher Dalbar has once again shown that the average investor in the US has made lower than market returns due to the effects of emotions and market timing. The average investor would have lost 41.6 per cent compared to the fall of 37.7 per cent fall in the S&P 500 in 2008.

Diversification still added value in 2008 despite the turmoil. Investors who have di-

versified portfolios with government bonds would have performed better than those who held only equities. Investors with Managed Futures would have performed even better as this class of alternative investment rallied in the one directional market in 2008. According to EurekaHedge, Managed Futures returned 16.88 per cent in 2008 when the MSCI World was down 42 per cent. However, this does not mean that Managed Futures will continue to give such stellar performance going forward. In fact, many of them have given negative returns in March when the world markets rallied. This difference in performance again showed the benefits of diversification.

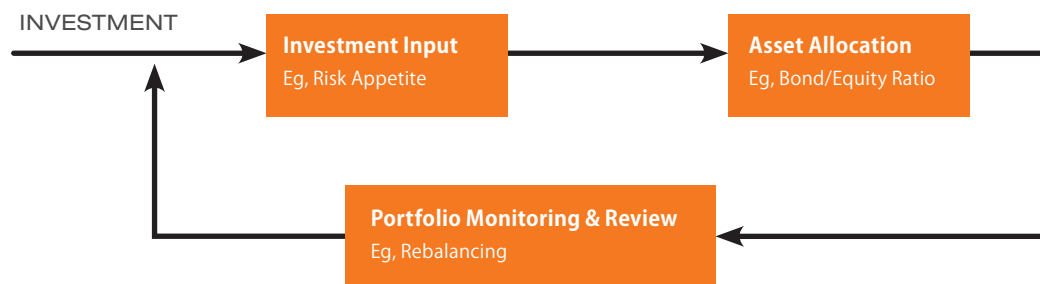


Figure 1

Buy-and-Hold does not mean Buy and do nothing. Buy low sell high is the simple answer to making money in investing. This is easier said than done. Many investors ended up buying high and selling low due to market timing. Too often, investors find themselves having profits in the first place but suffered losses in the end when they waited for the price to continue rising, only to disappoint themselves. Valuing an investment can be more of an art than a science. To avoid the predicament of staring at good profits only to see it vanish before your eyes in a tumbling market, one can practice Rebalancing.

Before going into what is Rebalancing, let's look at how a proper investment portfolio can be structured. A typical investment

process will start with gathering the necessary inputs like Objectives, Risk Profile, Investment Horizons and others. With that in place, Asset Allocation decisions can then be made to cater to the investment requirements. After setting up the portfolio, Portfolio Monitoring and Review has to be carried out to ensure that the portfolio is still appropriate and relevant. Portfolio Rebalancing forms part of the Monitoring and Review process. Figure 1 illustrates how a typical investment process can be carried out.

Rebalancing is the practice of periodic selling of part of the better performing investments and buying into the non-performing ones to restore the whole portfolio back to the original asset allocations. This forces the investor to buy low sell high while remaining invested in the market. Should the market continue to rise, the investor would still be making money. Should the opposite happens, the damage is mitigated as profits have already been taken.

To see how Rebalancing works, let's consider a hypothetical \$100,000 diversified investment portfolio made up of a 80/20 Bond to Equity allocation¹. The following figures compare the performance of rebalancing at the end of each year versus no rebalancing over 10, 20 and 30 years up to end of 2008 assuming no cost.

What can be seen from the results is that rebalancing has done better in all 3 scenarios. The greatest difference came in the study for 30 years. The greatest out-performance from Rebalancing came after major downturns. This came as no surprise as investors will be buying low through rebalancing during downturns and thus enjoy the upside when the market rebounds.

Rebalancing will not help you make money in all kind of market conditions. A good example is the Japanese stock market. The NIKKEI index reached the historical high of 38,957 in December 1989. Since then it has fallen drastically without reaching the historical high again. The index stands around 9,000 at the time of this article, a fall of 77 per cent from the high. An investment portfolio with a Japanese allocation would allocate more funds to this market in the nearly 20 years

¹ Equity Allocation: US - S&P500 (35%), Europe - MSCI Europe (30), Japan - NIKKEI (15%), Hong Kong - Hang Seng (5%), South Korea - KOSPI (5%), Taiwan - TWSI (5%), Singapore - STI (5%)
Bond Allocation: Composite Index (From 1970 to 1991, using US 10 Year Bond Yield, from 1992 to 1997, using OCBC Savers Global Bond Return, from 1998 to 2008 using 50% OCBC and 50% DWS Lion Bond Fund
Source: iFast Financial

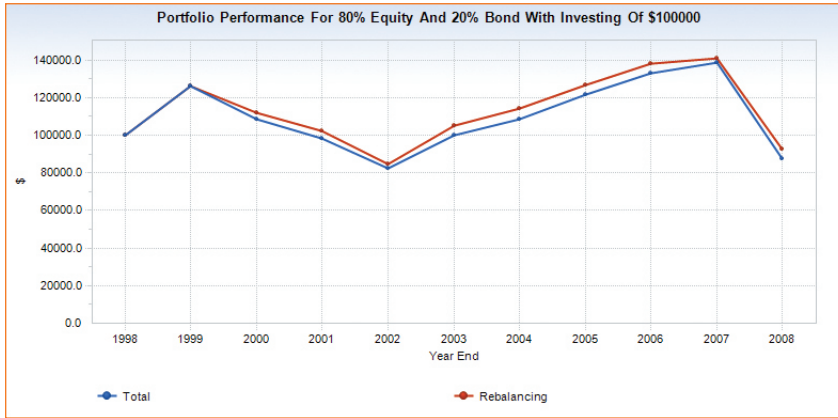


Figure 2: Rebalancing Over 10 Years

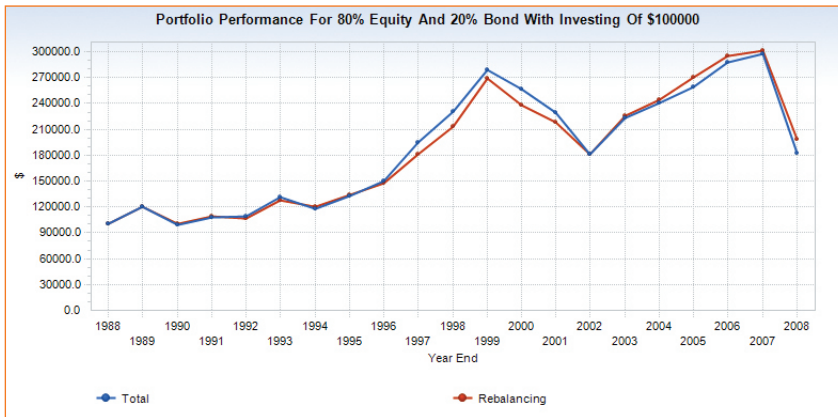


Figure 3: Rebalancing Over 20 Years

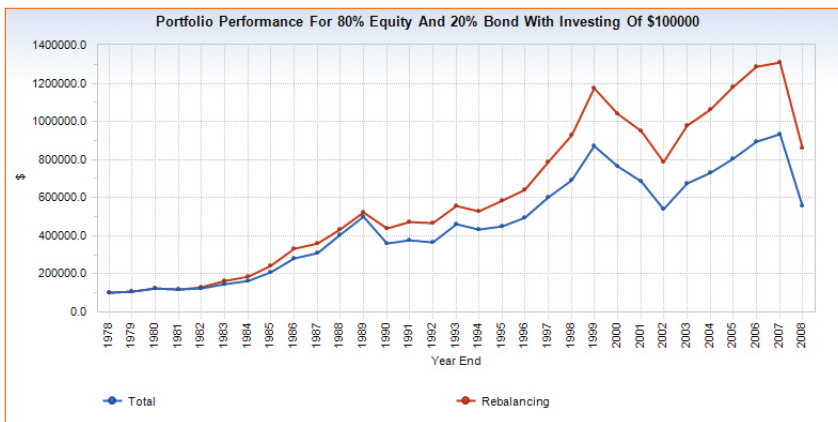


Figure 4: Rebalancing Over 30 Years

of downturn using a Rebalancing strategy. However, having a diversified portfolio would minimize this potential problem. A good example is the hypothetical portfolio used in this study which has a 15 per cent allocation to the NIKKEI.

In a market bubble, Rebalancing would also help the investor take money off the table before the bubble bursts. However,

this would also cause the investor to underperform when the bubble is forming. The investor must be disciplined as market bubbles could take years to form and it is not too pleasing to see lower profits on a runaway market. The true value of Rebalancing can only be seen when the bubble bursts.

Like many investment theories, Rebalancing is simple but not easy. The theory

sounds simple enough – reallocate your funds back to the original allocation after the change in portfolio makeup due to the difference in performance in different asset class or geographical holdings. The actual implementation of the strategy is a different story. There are two main obstacles – Psychological and Practical. The Psychological barrier comes from the need for great discipline and the counter-intuitiveness of the action. Many investors would be rushing to put money into a booming sector instead of taking money out. The Practical barrier is due to complication by the dispersion of investments over different platforms. It takes a significant amount of effort to rebalance a portfolio scattered over many platforms. A flexible centralized platform would be immensely helpful in determining Rebalancing decisions and cutting down the amount of administration work.

The bull market had been charging since 2003. All parties come to an end. The party ended in 2008. If proper Investment Planning and Rebalancing has been carried out, there can be spare cash to prepare for and enjoy the next party. For those who have not done so, it may not be too late to invest in the proper way. ■

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