The (Re)balancing Act

A disciplined approach to aligning assets with long-term objectives
“Should we, or shouldn’t we”? This was the critical rebalancing question many investors faced in March following the sharpest bear market drawdown in more than a decade.
The precipitous drop in stock markets left most institutional owners of assets—pensions, endowments, foundations and sovereign wealth funds—underweight equities by 5 percent to 7 percent relative to their strategic targets.¹

Complicating the rebalancing decision were a range of factors, including the pace and magnitude of the drawdown, as well as unusually low levels of liquidity in the fixed income markets. Investors therefore found themselves wrestling with the strategic question of whether they should stick to their rebalancing discipline or hold off, while simultaneously facing the more tactical challenge of sourcing sufficient liquidity to sell bonds in order to fund equity purchases.

As we approach the end of the second quarter and another rebalancing decision point for many large investors, a review of what investors did and the results they achieved in the first quarter can offer constructive guidance regarding the long-term importance of a disciplined rebalancing strategy. While the pace with which equity market dropped was more severe than a typical bear market, in this instance, disciplined rebalancing proved to be the right course.

¹ State Street, as of March 24, 2020
Recap: What Happened in March?

By the middle of March 2020, investors observed as equity markets struggled to find a floor. According to the MSCI World Index, stocks were down 29.6 percent from their peak just a few weeks earlier.²

The COVID-19 virus was spreading at increasing rates across the world. Markets were considering the dire procedures enacted during economic shutdowns to help contain the virus that lead to significant sell-off in global equity markets. Investor sentiment was low as the Volatility Index moved from 15.5 on February 20 to a peak of 82.7 on March 16.³ For both calendar-based and range-based rebalancing approaches, investors faced a number of options:

- Execute adjustments using synthetic overlay exposures to align with policy beta targets
- Delay the rebalance for a better equity entry point
- Adjust the direction and size of the trade based on a market view
- Start the rebalance process early to avoid potential month-end liquidity challenges
- Transition the trading across multiple tranches

Investors were helped in this decision by the introduction of Central Bank programs and the sharp rebound in equity prices over the final few days of March. The Federal Reserve announced the Commercial Paper Fund Facility and Primary Dealer Credit Facility on March 17, which were the first of six programs designed to provide meaningful liquidity to the markets, offsetting the natural sellers of bonds in this challenged market. Furthermore, with stocks declining on March 23⁴ and sharply rallying into the month end, investors had some of their Multiple Importance Sampling (MIS) weights reduced.

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² Source: Thompson Reuters. February 12, 2020 through March 13, 2020
³ Source: Thompson Reuters
⁴ Source: Thompson Reuters
How Did Investors Respond?

Across the universe of institutional owners of assets, we see that most investors took some action based on both external and internal sources of data.

NEPC Investment Consulting conducted a survey of endowment and foundation (E&F) clients and found that 16 percent of E&Fs did a full rebalance back to their policy targets, but a much larger 44 percent took action towards target. Many raised cash (14 percent) and only a small proportion (7 percent did not take any action.  

This analysis aligns with our own data sourced from top US-defined benefit plans that custody their assets with us. To analyze the rebalancing decision, we constructed a universe of 27 US clients who are US public funds and corporate defined benefit (DB) plans, representing a total of US$1.2 trillion in assets. We analyzed their holding in equities, fixed income, cash and alternatives relative to the policy target weights to determine the action taken over the course of March and April 2020. A review of this data results in a number of observations:

- In mid-March, the median drift from equity targets was 5 percent underweight (Chart 1). That underweight was reduced to 3 percent by the end of March, mostly through the equity rally although the mean flow into equities (i.e., the component driven by investor action rather than market movements) was only 0.4 percent for the same period. Since then, the underweight has declined at a gradual rate, implying that these asset owners are either taking a specific market view or have not taken additional actions to rebalance their portfolios.

- Fixed income allocations told the opposite story. As equities fell and bonds rallied, the median mis-weight relative to targets peaked more than 2.8 percent but was only 1.6 percent at month end. Investors shifted 2 percent of their portfolios from bonds over the course of March, and by the end of April most portfolios were in line with targets.

- Cash was also a beneficiary, both of market dislocation but also of a shift from fixed income. The overweight to cash has steadily increased over the course of the year to date and remained over 2 percent at the end of April. This has been consistent with the rise in cash and money market assets, now estimated to be over US$2 trillion in US cash by the side lines.

- The allocation to alternatives varied over the course of the quarter, oscillating between under and overweight relative to targets. The majority of these changes can be attributed to the lack of market to market for the private market investments during a period where the public securities were moving significantly. However, it is interesting to note that over this year to date, the flow into alternatives saw a 1.4 percent increase fairly consistent over the four-month period.

Chart 01: Equity (median) – asset class weight excess relative to plan

Chart 02: Fixed-Income (median) – asset class weight excess relative to plan
Chart 03: Cash (median) – asset class weight excess relative to plan

Chart 04: Alternatives (median) – asset class weight excess relative to plan
The sharp recovery that equities experienced is a good reminder of the importance of having a disciplined rebalancing strategy.

While this fall and recovery were much faster than a typical bear market, potential delay proved to be costly. An analysis of two hypothetical investors highlights this issue. Both investors began 2020 in line with their same policy weights.⁶ Investor A rebalanced their portfolio on March 31, and by the end of May returned minus 5.3 percent. Investor B did not rebalance, and posted a minus 6.0 percent return over the period. Over this same time period, a rebalance rule based on 5 percent bands around policy weights would have triggered on March 13 and would have resulted in a minus 5.1 percent return.⁷

The example above is admittedly a single and simple example, but highlights the importance of a disciplined approach to rebalancing. As portfolios grow over time, such a strategy allows for profit taking and risk management. In times of market stress, it also forces a contrarian trade to purchase assets (often equities) at lower valuations.

For many investors, a strategy that is based on the calendar or bands can offer a simple approach. Our experience has been that selecting a frequency that allows for some benefits of market momentum (following the “let your winners run” motto), can provide higher risk-adjusted outcomes. Examples may be a quarterly rebalance frequency or ranges that are plus or minus 5 percent around policy weights.

As a further refinement, investors could also consider the unique circumstances of the current environment and incorporate views on size and speed of a market recovery once a rebalance is triggered. For example, consider a portfolio that is overweight equities by 5 percent which would normally result in a portfolio rebalance. As part of the review process, the investor takes a positive view on stocks. This could result in a partial rebalance, e.g., to a half-way position, so that risk continues to be managed but some acknowledgement of the current environment can be taken into account. Of course, to be successful over time, a well-developed investment process is necessary to be effective in this approach.

⁶ Sample policy weights of 33% Russell 3000, 27% MSCI ACWI ex US IMI, 8% FTSE EPRA NAREIT Developed Index, and 32% Barclays US Aggregate Bond
⁷ Source: SSGA Investment Solutions Group
So, “should we or shouldn’t we”? Whatever the approach, the key is to consider how the rebalancing strategy aligns with portfolio objectives and to maintain the discipline to follow through when markets are in turmoil. Having these rules in place will help maintain the risk profile consistent with strategic allocation decisions and can reduce the questions in extreme situations, when it is often most difficult to align with the long-term objectives of the portfolio.