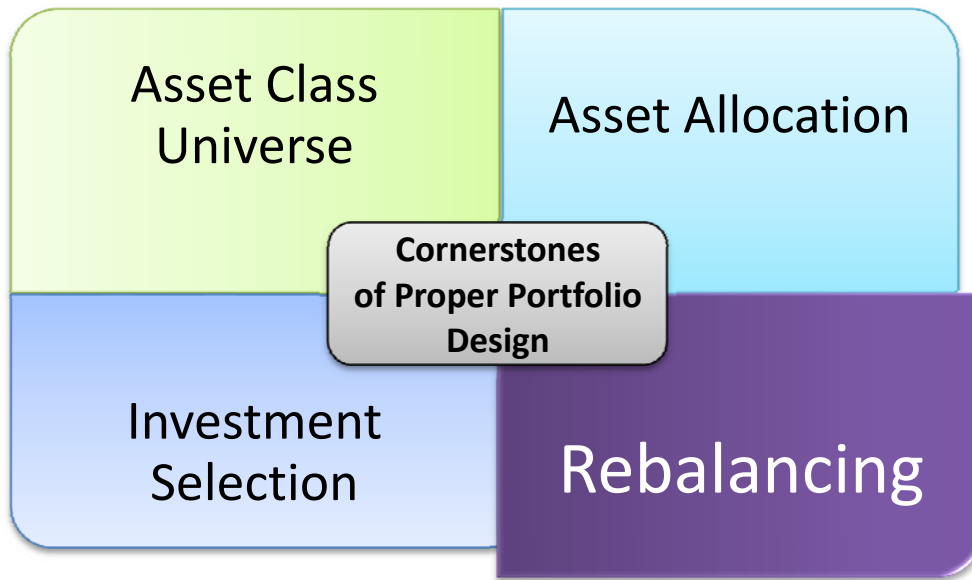


Cornerstones of Proper Portfolio Design

A four-part article series for financial planners and advisors

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Part 1: Variance-based Rebalancing.

Variance based rebalancing should be a cornerstone of every financial plan.

I have long reminded advisors that the most important aspect of any financial plan should be the return assumptions used for the client's portfolio. This is because most financial remedies are required as byproducts of too much or too little portfolio value. Think about it: a portfolio that doesn't eventually exceed allowable estate tax exemptions will not necessitate the purchase of second-to-die life insurance or if the portfolio can't sustain the withdrawals required during retirement, the money will evaporate. (Please keep in mind that the life insurance company offering income guarantees at a future date can suffer from the same fate.)

For the purpose of this writing I will not discuss the proper ways to estimate or forecast the impact of future returns that are not constant and positive, but instead I will discuss the need for variance based rebalancing.

Let's start with basics of portfolio management in the eyes of the financial planner. For most, the development of a portfolio consists of a two step process. The first step is to decide on the proper asset allocation and the second step is to select the investments to be representative of each individual asset class.

In the interest of remaining succinct, I will not be addressing the asset allocation selection process nor will I discuss the merits of active management versus passive management here. I will discuss those aspects at length in future articles.

Instead, what I will address here is the need for a third step in your process: a Rebalancing strategy.

In the well known studies conducted by Brinson, Beebower and Hood in 1986 and Brinson, Beebower and Singer in 1990, asset allocation was the greatest determinant of portfolio performance. The impetus for their studies was to determine the best application of an investment advisory firm's resources.

With this in mind, rebalancing is a very critical part of the asset allocation policy. Rebalancing is the process of buying and selling investments within a portfolio for the purpose of bringing the portfolio back to the target asset allocation. And since asset allocation accounts for the most of a portfolio's performance, as demonstrated in the studies noted above, a rebalancing strategy is imperative.

When I was an investment advisor in the 1990's I simply performed rebalancing actions monthly or in some cases quarterly. However, there was no real rhyme or reason beyond the fact that since the process was so time consuming, the frequency was a decision of physical ability.

Since the turn of the century, it has become commonplace for many financial product platforms to provide an automatic monthly or quarterly rebalancing. This automation has provided a time savings to the advisor, but there has been very little innovation in the resulting service or benefits delivered to the consumer.

For most advisors, the rebalancing decision remains simply a choice of calendar frequency (e.g. monthly or quarterly). However, an investment advisor has a fiduciary responsibility to select the best strategy available. Which is best? This challenge was given to a group at MIT by State Street Global and their conclusion was that variance-based rebalancing was the optimal rebalancing strategy.

Variance based rebalancing is a process of rebalancing when a portfolio becomes askew beyond an acceptable tolerance. Variance based rebalancing is the most appropriate rebalancing method for a financial planner and their client because it offers the most attentive relationship.

Rebalancing simply because it is the first day of the month, or because the last quarter just ended, has nothing to do with the needs of the client or the portfolio. Since rebalancing options have not been readily available for cost effective implementation, investment advisors have not included much thought into the design of their investment policies.

As in most industries when a meaningful innovation is first offered, users don't understand the reason to change or adopt the innovation. I developed the Minuteman as a cost effective implementation of a variance based rebalancing strategy. It is a completely automated process that monitors model portfolios each minute of the trading day. When an asset class exceeds the tolerance set in the rebalancing strategy, Minuteman places all required trades to rebalance all client account - automatically. It doesn't get much easier.

So, what is your rebalancing strategy and why do you use it?

