

Rebalancing in a Crisis

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Dramatic and ongoing declines in the equity markets across the globe have caused some to question whether adhering to their policy portfolios and rebalancing rules still make sense. In general, Russell advocates sticking to one's policy targets and continuing to follow existing rebalancing rules as long as this remains feasible. Investment principles and historical lessons support this approach, however it is during periods of market stress and uncertainty that these policies become particularly important.

The severity of current market conditions may mean that, in some cases, adhering to your rebalancing policy may simply not be feasible due to liquidity, cash flow, or collateral constraints. In these circumstances, the normal operation of the policies may be constrained, demanding careful consideration of how best to adhere to those policies in the light of those constraints.

Background

As a starting point, it is helpful to review what a rebalancing policy is designed to do in the first place. These policies:

- capture the long-term market exposure of the strategic policy
- take the emotion out of rebalancing decisions by instituting a mechanical approach to managing asset allocation drift

In terms of rebalancing, pension funds generally fall into two groups:

- Those who manage rebalancing themselves, generally through physical securities, with periodic checks to compare actual weights to policy ranges
- Those who have engaged an external rebalancing agent who generally uses a combination of derivatives (generally exchange traded futures) and physicals to rebalance

Clients who manage the process themselves most likely faced (or may still face) the difficult decision of selling fixed income and buying stocks. We encourage these clients to go ahead with this rebalance. We note that liquidity or other issues may present practical barriers to this action in some cases. In extreme cases, it is even possible that deviation from the stated rebalancing policy may be unavoidable. Clearly, any deviation from policy in these times of market stress carries unusually high risk and should be avoided where possible.

If rebalancing is implemented via futures, daily settlement of gains and losses makes the impact feel more real than simply a change in market value. It is important to remember that the impact is economically equivalent to the same position being taken with physical securities. It is also important to remember that the futures positions associated with rebalancing are a hedge (these positions offset unintended physical exposures). Therefore, whether the hedge is winning or losing, it is simply offsetting the opposite impact somewhere else in the portfolio.

This said, any exposure to risky assets has been very painful for all investors. It is natural to question policies (both asset allocation policies and rebalancing policies) at such a time. We review below the case for staying the course followed by a discussion of the practical barriers that may prevent some clients from doing so.

Staying the Course

In times of market extremes, it is human nature to believe that 'this time is different.' While there is no doubt that the world is facing a serious financial crisis, it is helpful to remember that things felt different in the bull market of the late '90 s (Internet, productivity gains from

technology) and in the correction that began in 2001 (there had never been a terrorist attack on U.S. soil), but, in the end, things returned to a version of normal.

Today, equity markets across the globe are down dramatically. There may be more to come, but the market has already priced in some very bad news and for equities to correct further, actual experience would need to be worse than the market currently expects.

For tactical shifts to be successful, you have to get two decisions right:

- The first is when to get out
- The second, and often more difficult, is when to get back in

To have any chance of recovering the value lost in 2008, you need to be fully exposed to the market when it recovers.

Switching Horses

Some clients may find themselves questioning whether the original premises of the rebalancing policy were flawed. The implication of this thinking is that a client may no longer believe in a positive return spread between equities and bonds and/or that the contrarian nature of rebalancing (buy low/sell high) is no longer appropriate. This could be a significant deviation from established and long-held practices and the support for these beliefs should be given careful consideration before discarding them.

Clients who have high conviction in a tactical bet that the downside risk of equities at current valuations is greater than the upside potential may use that as justification for changing their targets. Those choosing to do so should recognize that even small changes to one's asset allocation can have dramatic results (sometimes positive, sometimes negative) on performance, often swamping all other investment decisions combined.

Similar comments would apply to those who view the current situation as a buying opportunity and would look to overweight equities as a tactical position at this time.

Many will find that their funded position has declined in this market. This could lead to a need for more risk taking and, perhaps, an increase, rather than a decrease, in the allocation to risky assets. Given the strategic nature of this decision, it is not one that we would recommend making without due analysis of the overall position of the fund jointly considering the assets and liabilities.

Path Dependency

In closing, we note that performance often hinges on how the portfolio is positioned at the turning points. It is not possible to change past negative performance, although it is easy to crystallize losses. While the appropriate response will vary by fund, we would restate our position that the asset allocation and rebalancing policies have become even more important in these times of extreme market conditions, and that these are the times in which investment discipline is most needed.

What is happening in the capital markets right now is nothing short of spectacular and the decisions we make today will have a lasting impact.

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