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Rebalancing for Taxable Investors

Brown Brothers Harriman (BBH) considers manager selection to be the primary driver of long-term returns. That being said, taxable investors are inevitably faced with asset allocation and portfolio construction decisions that have the potential to add or detract from the compounding of their capital. An important aspect of these decisions relates to the rebalancing of portfolios back to the asset allocation targets that have been established. What follows is an exploration of best practices for rebalancing as well as a discussion of the trade-offs that should be considered to help clients make well-informed decisions when rebalancing portfolios.

Asset Allocation and Rebalancing

Before we discuss BBH's philosophy on portfolio rebalancing, it is helpful to review our framework for asset allocation. At BBH, we work to establish a target asset allocation that balances a client's desire for return with his or her ability and willingness to accept risk. At its core, asset allocation is an exercise in balance sheet management. Just like companies, individuals and families have assets and liabilities. Family liabilities might include future tuition payments or the desire to retire at a certain age, engage in philanthropy or leave wealth to future generations. Setting the appropriate asset allocation is both an art and a science, and each client's portfolio is developed to ensure that his or her unique circumstances and objectives are appropriately reflected by the balance of equity and fixed income in the resulting portfolio.

In this context, we think about rebalancing as primarily an exercise in risk control – that is, one that keeps a client's portfolio characteristics in line with the target asset allocation that has carefully been developed. Rebalancing is especially important for clients that have chosen a portfolio that includes a fixed income allocation. For example, if a client desires high returns, has no risk constraints and does not have an aversion to large drawdowns, he could simply invest 100% in equities, and the frequency and volume of rebalancing would be much lower. In this case, rebalancing would be constrained to occasional realignment of equity sub-asset class weights (for example, domestic vs. international equities). Because most investors have a lower risk tolerance, they will have a blend of higher-returning equity-oriented investments and lower-returning fixed income-oriented investments. These portfolio weights will drift based on the relative performance of the various asset classes, and as a result, the portfolio will gradually take on materially different risk characteristics over time. Rebalancing is the process that minimizes risk relative to the target allocation that the client has specified.

Practical Considerations in Rebalancing

Rebalancing is a multifaceted concept. Among other rebalancing decisions, investors can rebalance at the major asset class level (cash, fixed income, equity and real assets), the sub-asset class level or even the manager level. Additionally, investors can rebalance on a set calendar schedule or do so only when an asset class drifts by a predetermined level from its target.

Before stepping into the markets to rebalance a portfolio, investors should always consider if their situation has changed and whether their investment policy statement (IPS) reflects their current circumstances. It is not uncommon for a client's risk tolerance to increase over time as her wealth compounds in excess of her spending needs. In these cases, a portfolio with a higher equity allocation may be appropriate, and the investor may be able to amend her IPS to specify her desire for a portfolio with a different target asset allocation. As an example, consider a client that has grown her assets from \$10 million to \$20 million in 10 years and, as a result, has an equity portfolio weight that has drifted above original targets. If this client has had only minimal increases in the amount of spending expected from her portfolio, then she may have an increased ability to accept risk, and it could be appropriate to consider changing the portfolio's target asset allocation to include a higher equity target and not rebalance.

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If investors do need to rebalance, however, they should first seek to rebalance the portfolio through low-cost methods, including the following:

Rebalancing with new money: Investors that are still creating wealth outside of their portfolios should consider rebalancing their portfolio with new inflows. To the extent that these cash inflows are meaningful in relation to the total size of the portfolio, they can reduce or eliminate the need to realize capital gains.

Rebalancing with interest, dividends or distributions from private funds: The same logic applies to cash flows generated from within the portfolio. If the investor does not need to use dividends, income or distributions for spending or for commitments to private funds, these amounts can be used to rebalance the portfolio with no additional tax impact.

Gifting appreciated shares: Investors should consider how their philanthropic plans play into rebalancing decisions. It is much more tax efficient to make charitable donations via appreciated shares as opposed to cash.

Asset allocation: Investors should carefully consider the use of tax-advantaged accounts and the investments held within them. Before selling appreciated investments in a taxable account, investors should consider whether there are portfolio changes that can be made in any tax-advantaged accounts that reduce the need to realize gains.

While these low-cost methods are highly practical ways of rebalancing without realizing capital gains, portfolios may drift from targets enough where it becomes necessary to sell securities (and pay taxes) to bring portfolios back in line with a client's targets and risk tolerance levels.

One of the most important decisions is whether to pursue a calendar-based or threshold-based rebalancing methodology. In a calendar-based system, asset class weights are rebalanced back to target on a set schedule, regardless of how far the portfolio has drifted. Such rebalancing trades are usually smaller and more frequent. Alternatively, investors can establish rebalancing ranges, or bands, around targets and rebalance only when asset class weights fall outside of this band. This rebalancing system allows the portfolio to run for longer periods of time, and the eventual rebalancing trades are thus larger but less frequent. Such triggers can be absolute in nature (for example, a +/-10% absolute band would mean rebalancing equities at 20% or 40% for a portfolio with a 30% target) or relative (for example, a +/-25% relative band would mean rebalancing at 22.5% or 37.5% for a portfolio with a 30% target). Because the need to rebalance is driven solely by how much a portfolio weight differs from its target, calendar-based rebalancing offers little benefit to investors and incurs unnecessary transaction costs. Therefore, at BBH, we prefer a threshold-based rebalancing system.

Analyzing the costs and benefits of different rebalancing strategies is quite difficult, but thankfully, there is a large body of academic research on this topic. The intent is to set the bands wide enough to avoid unnecessary portfolio turnover but narrow enough so that the portfolio does not drift to an unacceptably different risk profile. At BBH, we believe it is optimal to rebalance at an absolute deviation of 5% at the major asset class level but a relative band of +/-25% at the sub-asset class level. For example, a Balanced Growth Portfolio with a current target of 68% equity would be rebalanced if total equity falls below 63% or rises above 73%.[1] In addition, each sub-asset class within the portfolio will have a 25% relative rebalancing band assigned to it (for example, a 7.5% to 12.5% range where the target is 10%). We chose this system because we believe it is most important to keep overall equity targets close to their intended weight and that sub-asset classes can be allowed greater freedom to compound before their changing weights begin to materially change the risk characteristics of the portfolio. For context, a 60/40 (equity/fixed income) portfolio that experienced equity returns of 30% and fixed income returns of 5% would drift to a balance of 65/35 that would trigger a rebalancing trade.

Another consideration in rebalancing is liquidity. Individuals and institutions that invest in private markets should consider the weight of both liquid and illiquid asset classes when rebalancing. Because illiquid investments cannot be easily rebalanced, the publicly traded equivalent investment (for example, public equity for private equity) may have to overcompensate for illiquid investments to keep asset allocation targets on track.

Taxes and Rebalancing

Of course, no discussion of rebalancing is complete without considering the impact of realizing capital gains and paying taxes. The realization of gains disrupts the long-term compounding of capital; however, even though taxes are a known cost, the peak-to-trough drawdown of a portfolio during periods of stress can prove to be far larger than the known tax hit from rebalancing.

Take the example of an investor with a $10 million portfolio composed of $6 million of equity and $4 million of fixed

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income. If this investor's target allocation is 50% equity and 50% fixed income, then he should sell $1 million of equity and buy fixed income with the after-tax proceeds. If the realized gains amounted to 50% of the sale proceeds, the rebalancing would create a tax bill of $119,000.[2] The portfolio would now be rebalanced back close to its 50/50 target but would total $9.9 million instead of $10 million. Consider what might happen in a drawdown scenario, though, where equities decline 30%, and fixed income increases 5%. In this case, the rebalanced portfolio would decline to $8.6 million, whereas the original 60/40 portfolio would decline to $8.4 million, a difference of $246,000. Furthermore, after the drawdown, the market would have moved the 60/40 equity/fixed income portfolio to 50/50, but the portfolio that was rebalanced prior to the drawdown would now be 40/60 equity/fixed income, or 10% underweight to equities. The "rebalanced" portfolio would be able to sell fixed income (with minimal tax impact) and buy equities (arguably at discounted prices) to return its asset allocation to its target of 50/50.

While scenarios like this tend to happen only a few times in a market cycle, the benefits of rebalancing in such instances are clear. The contrarian nature of rebalancing can at times be beneficial to portfolios – both when selling equities and subsequently repurchasing them – and in certain instances, this benefit can prove to be greater than the upfront tax cost. BBH believes that, unless client circumstances, including future family liabilities and risk tolerances, have changed, rebalancing is an exercise that should be undertaken.

Tax Deferral vs. Tax Realization

While rebalancing requires selling securities and paying taxes, investors should be careful not to assume that they can avoid taxes forever simply by not rebalancing. Taxes will be realized over time by both turnover within each manager's portfolio and from client withdrawals. Even managers that run extremely long-term-oriented portfolios will realize taxes, and sometimes taxable mergers and acquisitions remove the tax realization decision from the hands of the managers. It is therefore shortsighted to allow a portfolio to take on unintended risks in an attempt to avoid taxes. Importantly, delaying a rebalancing decision is not advisable, as declines in the value of the investment can quickly erase any slight advantage gained from delaying the realization of gains.

To further this point, one study analyzed a threshold-based rebalancing strategy from 1990 to 2004, quantifying both the rebalancing benefits as well as the cost in terms of forgone opportunities to defer taxes (and to allow the portfolio to continue compounding).[3] The study found that this tax deferral penalty from rebalancing amounted to only 5 basis points (bps) over the 14-year period vs. a rebalancing benefit (that is, increased portfolio returns) of 55 bps. The exact cost/benefit analysis from rebalancing will depend on the specific time period in question, but it is worth noting that rebalancing adds the most benefit to portfolios in volatile market environments. Rebalancing also reduces portfolio volatility (including drawdowns) in a more reliable way in addition to the benefits of keeping the portfolio on target with its asset allocation.

Conclusion

While rebalancing is an important tool in the asset allocation toolkit, there are trade-offs that need to be considered, and unfortunately, there is no one-size-fits-all solution. A number of factors, such as the expectation of large inflows or outflows, philanthropic plans and the presence of both liquid and illiquid securities, can lead to different rebalancing strategies for investors that hold similar portfolios. In addition, investors must ensure that they regularly revisit their IPS to assure it adequately reflects their current circumstances, as this will materially affect when and by how much the investor rebalances. BBH will continue to work with our clients to identify their unique situations and develop rebalancing strategies that make sense. ■

[1] *+/-5%.*

[2] *$500,000 * 23.8% = $119,000*

[3] *Daryanani, Gobind. "Opportunistic Rebalancing: A New Paradigm for Wealth Managers." January 2008.*

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