

Take Note

REBALANCING – THE BENEFITS OF A CONSISTENT APPROACH

For many of Russell's multi-manager fund clients, Russell's rebalancing team brings their funds back to their chosen mix – a process known as rebalancing. This Take Note describes Russell's chosen rebalancing method and explains the benefits of sticking to Russell's standard methodology.



Let's start by meeting the individual that has been responsible for managing the rebalancing process for Russell. Lucinda Downing joined the Investment and Manager Research team within Russell in 2002 and has led the team which has been responsible for supervising the rebalancing of all institutional client accounts in the London office, updating the systems to account for benchmark changes and maintaining the integrity of the rebalancing model and procedures. In this Take Note, Lucinda explains Russell's rebalancing process.

What is rebalancing?

Every few years, you review the strategy of your portfolio. Here, you set the strategic asset allocation that ideally trades-off your need for return with your appetite for risk. This is implemented via an allocation to different funds. However, the actual allocation begins to vary immediately as markets move relative to each other. If the allocation is allowed to drift, the fund will either end up with a higher mix of riskier assets, resulting in a fund with higher risk than desired, or a lower mix of riskier asset, resulting in a fund with a lower expected return.

Lucinda points out that "to maintain this risk-return balance until your next strategy review, the portfolio's actual asset allocation must always remain close to its original strategic allocation. This reaffirms your commitment to the strategy and is an important part of fund governance." She explains that "whenever it doesn't, it should be 'rebalanced' back towards its strategic allocation through a series of transactions."

That is what we mean by rebalancing. Where possible, this should be performed using cashflows rather than physically switching assets in order to reduce costs.

Rebalancing is unequivocally a risk controlling exercise. However, the activity can at times add value as the underlying concept of realigning fund holdings entails selling funds that have risen (i.e. have become larger than their strategic weight) and buying funds that have fallen, or in other words, 'buying low and selling high'.

Russell's standard rebalancing methodology

Based on detailed analysis of the risk-return trade-offs, Russell has adopted the following standard rebalancing policy. Commentary on the choice of each factor is also given.

Portfolios are monitored daily to see if tolerance bands are breached. If so, client portfolios are rebalanced at the end of each month.

We follow a deviation-based rebalancing approach, rather than a time-based rebalance (such as once a month or a quarter). This means that we only rebalance fund holdings if they deviate significantly from strategy weights. If there are regular cashflows into an account, these help keep fund holdings close to the strategy and no other rebalancing trades are required.

"Ideally, portfolios should be rebalanced daily as there are continuous movements in the markets. However, this is not practical and will lead to high transaction costs. Given that small deviations away from the benchmark do not make a significant impact on the risk and return characteristics at the total portfolio level, allocations should be allowed to drift within certain ranges, only triggering a rebalance if the range is breached. We rebalance portfolios at the end of each month rather than at the breach date to benefit from the possibility that market movements will bring back fund holdings to within the tolerance range, potentially reducing transaction costs."

The tolerance bands are derived from Russell's research on the trade-off between the risk of deviating from strategy and transaction costs.

The tolerance bands are typically $\pm 3\%$ for each region and asset class, but can be different in certain circumstances.

"The tolerance bands should be large enough to prevent constant rebalancing, which will increase costs, yet small enough to prevent the allocation moving too far from the strategic allocation, exposing clients to undesired risk levels. We believe the chosen approach provides a fine balance between these two opposing influences."

The funds are not rebalanced to a pre-determined level. Any Fund holding that breaches the tolerance band is rebalanced back towards to its strategic weight using a proprietary rebalancing algorithm which trades-off expected deviation and transaction costs.

"Trades may occur that bring Fund weights back to benchmark, towards benchmark or even slightly through benchmark. By using an algorithm applied on a case-by-case basis to each individual rebalance rather than a blanket approach, the specifics of each case are considered. This minimises the total cost and deviation of the whole process."

This algorithm is also used to invest or disinvest cashflows when Fund holdings remain within tolerance bands.

A consistent approach to rebalancing lowers operational risk

We could adopt other rebalancing approaches for individual clients. However, our sophisticated method ensures that our clients' portfolios remain close to their chosen weights and, at the same time, minimise the impact of transactions.

More importantly, deviating from Russell's standard methodology does introduce unnecessary operational risks.

The key is consistency. Lucinda emphasises that "we believe that our clients benefit from its consistent application." For that reason, we ask new clients to adopt Russell's proposed rebalancing approach as part of their investment management agreement with us. This includes maintaining standard tolerance ranges around the client's ideal fund allocation and accepting our rebalancing methodology.

Why do we emphasise a consistent approach to rebalancing? Lucinda cautions that "if every client had a different rebalancing policy, the process would become much more complex. It would require human intervention to rebalance funds as it is impossible to program in every type of rebalancing rule. Human intervention in any process unavoidably introduces implementation errors, so we would encourage clients to accept our rebalancing process. Human intervention also increases the cost of monitoring and decreases trading efficiencies, increasing the total cost of rebalancing for clients. Indeed the most important point from a risk perspective is that we rebalance consistently across all clients."

Conclusion

Rebalancing is an important part of the investment process to ensure the allocation to different asset classes remains close to the desired mix, and hence the risk and return characteristics remain close to the desired levels.

In any business, it is important to keep things straightforward to avoid unnecessary errors. So in all our operational processes we aim for maximum simplicity to keep the risk of error to a minimum.

Consequently, in the absence of any significant alternative rationale we encourage all our clients to follow our robust and clear rebalancing approach, decreasing operational risk and costs.

Summary

Russell's standard rebalancing methodology

- Portfolios are monitored daily to see if tolerance bands are breached, rebalancing at the end of each month if necessary.
- The tolerance bands are derived from Russell research on the trade-off between the risk of deviating from strategy and transaction costs. They are typically 3% for each region and asset class, but can vary.
- Funds are rebalanced back towards the strategic weight using a proprietary rebalancing algorithm which trades-off expected deviation and transaction costs.

The benefits of a consistent approach to rebalancing

- Less complex process
- Less human intervention
- Reduced implementation errors
- Greater trading efficiency and reduced implementation costs