Take advantage of auto-rebalancing features

Rebalancing is key to managing portfolio risk

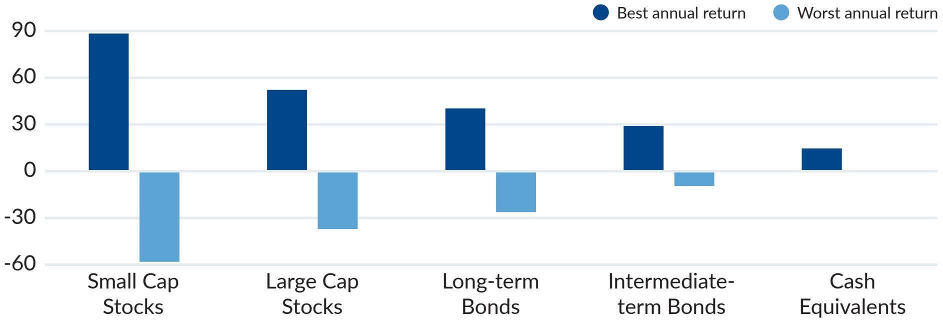
The purpose of rebalancing a portfolio mix is to control risk by maintaining a consistent risk level. This is particularly critical for portfolios with relatively shorter time horizons. Rebalancing a portfolio refers to selling and buying different investments in a portfolio to maintain a target asset mix. This might be done on a quarterly, semi-annual or annual basis, for instance.

In a typical market year, this process will sell off some of the investments that have risen on a relative basis to other investments in the portfolio and buying some more of those other investments that have risen less. In a down year for many investments, like 2022, this process will sell off the investments that have fallen less relative to other investments in the portfolio and increase the weight in the of the investments that have declined more.

For instance, if a portfolio consists of a target mix of 50% in a stock index fund and 50% in a bond index fund and the stock index fund rises to 60% of the total portfolio value and the bond index is now 40% of the total portfolio value over the course of a year, rebalancing will sell enough of the stock index and buy enough of the bond index to return the portfolio to the targeted 50/50 asset mix.

Figure 1 (below) shows the range of historical returns for different asset classes from 1936 to 2022, which is the best and the worst outcome in any given year. For an investor with a relatively shorter time horizon, an increased weight to shorter maturity bonds or cash equivalents can help to mitigate the downside risk of the portfolio relative to a portfolio with an increased weight to stocks.

FIGURE 1: BEST AND WORST ANNUAL ASSET CLASS RETURNS | 1936–2022



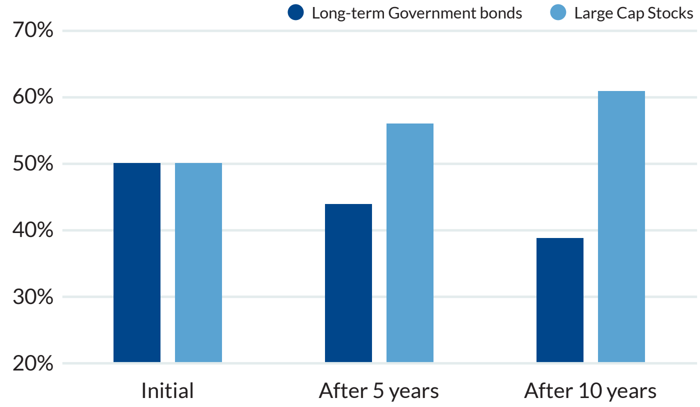
Source: MPI Stylus and Mesirow Calculations

Target Date Funds (TDFs) are utilized as a means of providing retirement savers with a one-stop solution suited to their age and, in some cases, risk-tolerance level. Asset mix glide paths decrease in portfolio risk level over a person's lifecycle, which at the most basic level means less stocks and more bonds and cash equivalents in the portfolio. Academic research has indicated that as an investor's time horizon decreases the ability to weather volatility shocks declines. Target date funds are designed entirely around the concept of managing risk and setting an appropriate risk level based on time horizon. These funds generally have auto rebalancing features built into their construction.

Taking advantage of auto rebalancing features provided by your plan's recordkeeper enables this same risk-control benefit for any targeted portfolio mix. Automated account rebalancing set to quarterly or even annually, through a participant web site, can help achieve desired outcomes over the lifetime of a participant's account. Why wouldn't an investor want to just let the relative "winners" in the portfolio mix ride and take on increased weight? Because over time, the portfolio mix will become riskier. Riskier means that there is both more potential variation in returns — and more downside risk — in any given year, but also more potential variation in ending wealth outcomes far into the future. For assets, like stocks, that have higher expected long-term returns, there is greater accompanying risk relative to bonds or cash equivalents, like Treasury Bills or Stable Value products.

Figure 2 (below) shows what can happen if investors do not rebalance their portfolios. This chart shows the changing portfolio weights over time for a very simple balanced portfolio that starts out ten years ago with a 50% weight to large cap stocks and a 50% weight to long-term government bonds. At the end of the period, the weight to stocks is over 60%, while the weight in bonds is less than 40%. With the passage of time, the portfolio has become riskier. It is exposed to a greater potential variation in annual return outcomes and greater variation of ending wealth values.

FIGURE 2: **THE IMPACT OF NOT REBALANCING**



Source: MPI Stylus and Mesirow Calculations

Rather than getting riskier with the passage of time, the ability of most investors to weather volatility shocks decreases with the passage of time. Utilizing auto rebalance features built into a plan's participant web site takes away this horizon risk concern for investors!

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[1] Mincer, Jacob. 1958. "Investment in human capital and personal income distribution." Journal of Political Economy 66 (4): 281–302

[2] Becker, Gary S. 1962. "Investment in human capital: A theoretical analysis." Journal of Political Economy 70 (5, Part 2): 9–49.

[3] Largest 401(k) Recordkeeper by number of plans, PLANSPONSOR Magazine 2022.

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Benchmark Descriptions

Cash Equivalents - IA US 30 Day T-Bill Index: Measures the performance of a single issue of outstanding Treasury Bill which matures closest to, but not beyond, one month from the rebalancing date. The issue is purchased at the beginning of the month and held for a full month; at the end of the month that issue is sold and rolled into a newly selected issue. The index is calculated by Morningstar and the raw data is from WSJ.

Intermediate-term Bonds - IA US IT Government Index: Measures the performance of a single issue of outstanding US Treasury note with a maturity term of around 5.5 years. It is calculated by Morningstar. Returns for 1934 to 1986 are obtained from the CRSP Government Bond File and returns for 1987 to 2014 are calculated from The Wall Street Journal prices.

Long-term Bonds - IA US LT Government Index: Measures the performance of a single issue of outstanding US Treasury bond with a maturity term of around 21.5 years. It is calculated by Morningstar and the raw data is from Wall Street Journal.

Largecap Stocks - IA US Largecap Stock Index: Tracks the monthly return of the S&P 500 index calculated by IA.

Smallcap Stocks - IA Smallcap Stock Index: The index measures the performance of DFA U.S. Micro-Cap Portfolio net of fees and expenses. The fund is designed to capture the returns and diversification benefits of a broad cross-section of U.S. small companies on a market-cap weighted basis. The fund's target buy range includes those companies whose market capitalization falls in the lowest 5 percent of the market universe defined as the aggregate of the NYSE, NYSE Amex, and NASDAQ National Market System or companies smaller than the 1,500th largest U.S. company in the same market universe, whichever results in a higher market capitalization break.

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