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 annual return outcomes and greater variation of ending wealth values. 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. 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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3. Largest 401(k) Recordkeeper by number of plans, PLANSPONSOR Magazine 2022.

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