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ASSET MANAGEMENT

Allocation Spotlight

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Raising the bar for rebalancing

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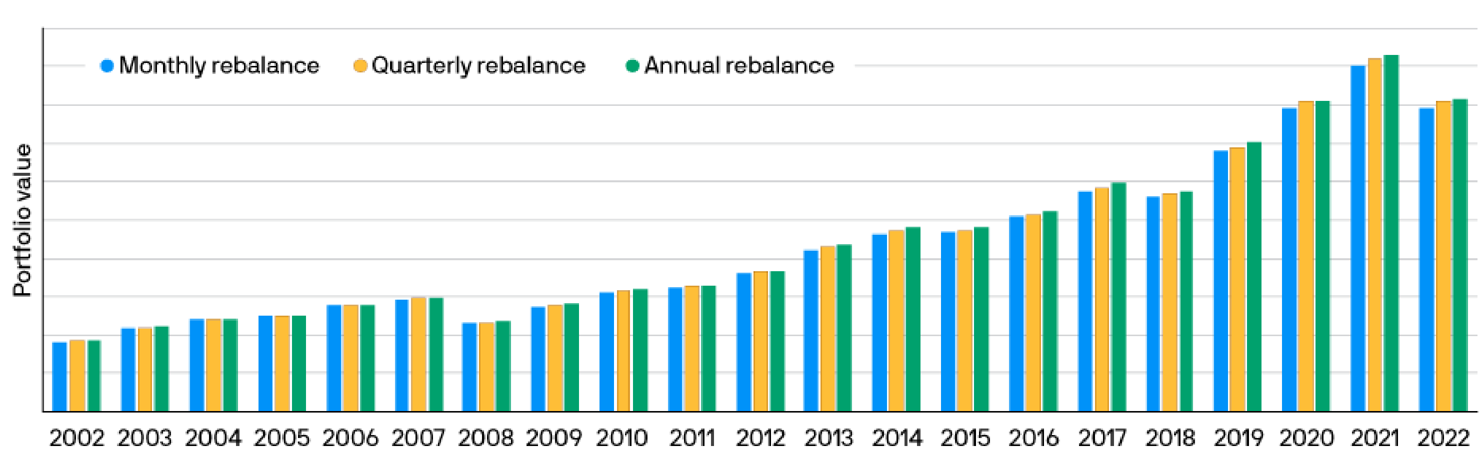
"Raising the bar for rebalancing – even in volatile markets – may raise returns over the long run"

When rebalancing adds value, it is equated with tactical skill; when it loses value, it is excused as strategic discipline. The opportunities for improving this process are apparent, but reconciling long- term investment strategy with short-term market movements is challenging.

Markets are currently experiencing a period of exceptional volatility, which will inevitably push asset allocations away from long-term strategic targets. The common response to this situation is to rebalance the portfolio back to target by selling assets that have relatively outperformed and buying those that have relatively underperformed the broader market. It feels like a safe assumption that selling recent "winners" and buying recent "losers" will add value over time, but investors should be careful. Placing confidence in the short-term mean reversion of asset class returns is little better than a coin flip. Simple mechanical rebalancing, unless structured correctly and applied narrowly, has limited value at best and the potential to actually damage performance (**Exhibit 1**).

Rebalancing frequently over short time horizons does not improve performance

Exhibit 1: Returns of a 60/40 portfolio with monthly, quarterly and annual rebalancing



Source: J.P. Morgan Asset Management; data as of May 31, 2022. Portfolio consists of 60% Russell 3000 Index and 40% Bloomberg US Aggregate Index.

Consider several points regarding rebalancing in theory and practice:

1. **Rebalancing should be seen for what it is: a middle ground between top-down annual strategic asset allocation reviews and the bottom-up adjustments made daily by active managers.** It's fair to ask how much additional value is achieved through rebalancing vs. simply letting these two processes run their course. Exhibit 1 illustrates that annual rebalancing is generally superior to shorter horizons, although for simplicity it assumes rebalancing back to a static 60/40 target portfolio. More likely, investors will conduct a comprehensive annual strategic review involving long-term capital market assumptions that incorporate a rigorous assessment of current valuations and future expectations. This process offers not just an opportunity to rebalance at a more optimal frequency but also an informed perspective on whether the benchmark itself should change to reflect the latest information. An annual process need not leave investors helpless in the face of short-term volatility; over shorter horizons, active managers can reallocate capital to attractive securities and sectors. The more flexibility active managers are given, the more effectively they can respond to the current environment.

2. **Rebalancing over short time horizons or after modest changes in value is hard to reconcile with the longer-term trends of financial markets.** Frequent sharp reversals over short time horizons are not the norm, yet mechanical rebalancing strategies are constructed around capturing just such movements. The reality is that significant market moves often continue for several years before reversing. Throughout history, the average bear market has lasted 22 months, while the average bull market has lasted 56 months (**Exhibit 2**). Investors who rebalance too frequently may end up adding risk in a protracted down market and limiting the compounding of market gains during a longer period of strong performance.

Large market movements tend to persist for years

Exhibit 2: Historical characteristics of bear and bull markets

Historical bear markets

	Market peak	Bear return	Duration (months)
	Sep 1929	-86%	32
	Mar 1937	-60%	61
	May 1946	-30%	36
	Aug 1956	-22%	14
	Dec 1961	-28%	6
	Feb 1966	-22%	7
	Nov 1968	-36%	17
	Jan 1973	-48%	20
	Nov 1980	-27%	20
	Aug 1987	-34%	3
	Mar 2000	-49%	30
	Oct 2007	-57%	17
	Feb 2020	-34%	1
Average:	**—**	**-42%**	**22**

Historical bull markets

	Bull begin date	Bull return	Duration (months)
	Jul 1926	152%	37
	Mar 1935	129%	23
	Apr 1942	158%	49
	Jun 1949	267%	85
	Oct 1960	39%	13
	Oct 1962	76%	39
	Oct 1966	48%	25
	May 1970	74%	31
	Mar 1978	62%	32
	Aug 1982	229%	60
	Oct 1990	417%	113
	Oct 2002	101%	60
	Mar 2009	401%	156
Average:	**—**	**166 %**	**56**

Source: J.P. Morgan Guide to the Markets, FactSet, NBER, Robert Shiller, Standard & Poor's, J.P. Morgan Asset Management; data as of March 31, 2022.

3. **The optimal rebalancing opportunity is when two asset classes move simultaneously in opposite directions.** After all, every purchase needs a sale, and vice versa. In practice, however, asset classes rarely provide such an obvious opportunity. Stocks and bonds, for instance, have generally exhibited a low or negative correlation, but certainly nothing close to the -1.0 level. Often, only one asset class has moved enough to

reach a rebalancing trigger, and the other side of the trade is a much less compelling pro rata buy or sale of the remainder of the asset allocation—despite there being little reason to believe that the more stable asset classes have become more or less attractive as investments. One possible alternative approach would be to hold cash in anticipation of future rebalancing opportunities. While this might seem appealing, the return drag that it would create over longer horizons would likely outweigh the benefits.

4. **Many alternative asset classes are fundamentally unsuited to participate in the rebalancing process—particularly if the intent is to use them as a source of liquidity.** It makes little sense to withdraw capital from private strategies that are built around carefully constructed portfolios of illiquid assets that accumulate value over long time horizons. Selling these strategies in reaction to volatility in public markets short-circuits this process. Further, since most private strategies target long-term returns in excess of public market equivalents, the level of confidence around the relative value would have to be exceptionally high before executing a private-to-public rebalancing. This is precisely the sort of circumstance in which a comprehensive strategic review is highly relevant: Any decision to liquidate long-term private investments—in real estate, for instance—to fund a rebalancing back to stocks or bonds should be considered only when informed by the adjusted long-term return expectations on both asset classes.

Improving future outcomes, not validating past decisions

Ultimately, this is not to suggest that investors abandon rebalancing altogether but, rather, that the bar be raised to the point where rebalancing becomes less common yet more likely to add value when it does take place.

With that goal in mind, we would suggest several potentially useful changes to the current model.

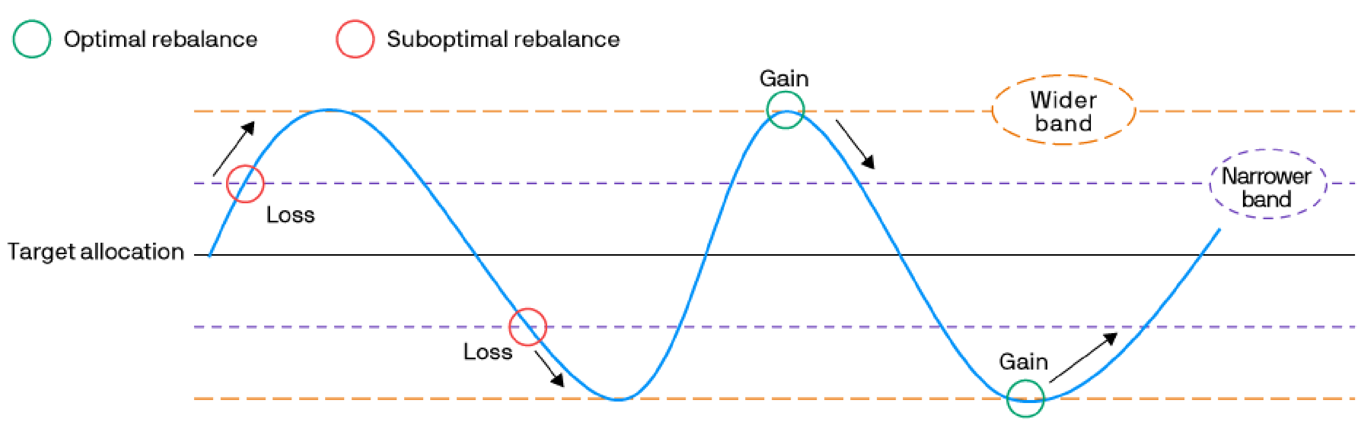
1. **Let the strategic asset allocation process do its job and serve as the primary mechanism for evaluating the relative value of asset classes and the portfolio structure.** Mechanical rebalancing is no substitute for a thoughtful process that incorporates the latest macroeconomic and market data alongside a rigorous asset allocation model. However, investors should also be willing to follow the strategic allocation process where it leads, shedding some of the inertia and incrementalism that often characterize this process. More dynamic annual strategic reviews are effectively a form of rebalancing, just more thoughtful and less frequent.
2. **Recognize that active managers are already adjusting their positioning in response to current market conditions.** Active managers, if given sufficiently broad mandates, can effectively rebalance risk within the scope of their strategies. Mandates that bridge multiple beta sectors offer a greater opportunity to add value. The most impactful version of this would be a tactical asset allocation strategy benchmarked to the strategic asset allocation but with a high degree of flexibility. Adding a tactical program at 5% or 10% of the asset allocation could meaningfully increase the responsiveness of the whole portfolio to

short-term market movements—and therefore make mechanical rebalancing less critical.

3. **Narrow the scope and widen the bands for traditional rebalancing activity** (**Exhibit 3**). This means that rebalancing should focus primarily on liquid public markets, where beta returns dominate, correlations are more predictable and transaction costs are low. Importantly, rebalancing should take place only when the relative movement of an asset class (preferably a pair of asset classes) away from the strategic target is great enough that confidence in a subsequent reversion increases. Rebalancing to the target is most likely to improve performance when large market swings occur during the time between strategic reallocations and with sufficient magnitude that active managers alone cannot adjust the strategic risk profile. Evidence suggests that using a much wider boundary (perhaps 10%) for rebalancing in lieu of monthly or quarterly triggers can improve outcomes.

Narrow rebalancing ranges can limit the upside and maximize the downside of potential returns

Exhibit 3: Widening allocation boundaries helps reduce suboptimal rebalancing



Source: J.P. Morgan Asset Management. For illustrative purposes only.

4. **Generally exclude private strategies from the rebalancing process—even those with access to liquidity.** Private strategies draw much of their value from the targeted selection of specific illiquid assets and the patient accretion of value over time. Due to the illiquidity of the underlying assets, private strategies tend to exhibit more stable performance, particularly when public markets are volatile, but this stability is not sufficient justification to use them as a source of rebalancing capital. Keeping private strategies out of the rebalancing process has two clear benefits: First, investors can avoid the higher transaction costs that characterize such markets; and second, well-diversified private strategies can reallocate capital internally across specific assets, sectors and geographies, taking advantage of market swings to patiently improve long-term positioning and performance.

Responding to the current market environment

Recent volatility has pushed asset allocations away from strategic benchmarks, prompting an understandable interest in identifying opportunities to rebalance. As investors consider the implications of moving in and out of various asset classes, the following thoughts may be helpful:

- Beta sectors may not be an attractive source of capital at the moment. When both stocks and bonds are down at the same time, a good entry point for one may be bad exit point for another. The probability of a rebalance adding value is diminished, suggesting patience may be a good option.

- Dry powder is exceptionally valuable right now, either in the form of cash or external contributions. The probability of fresh capital generating better-than-average long-term returns increases as valuations fall.

- The upcoming strategic asset allocation review is likely to be one of the most impactful in many years, offering forward guidance on changing macroeconomic assumptions, relative asset class performance expectations and optimal portfolio structure. It may be better to wait for this guidance than to engage in low-value rebalancing in the meantime.

Conclusion

Between the long-term strategic asset allocation process and short-term bottom-up active management, investors have flexible and effective options for responding to changing market conditions. Rebalancing to target can also serve as a simple mechanism for managing risk as markets move, but allocators should resist the temptation to always treat short-term market swings as a reason simply to return to the original allocation. History suggests that markets move in longer cycles and that short-term rebalancing adds little if any value. While a more restrained approach to traditional rebalancing is warranted, there is a strong case for the greater use of active tactical asset allocation, which introduces a level of skill and dynamism that is lacking in the strategic allocation process. Raising the bar for rebalancing—even in volatile markets—may raise returns over the long run.

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