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Mallard Advisors LLC

Comprehensive Financial Planning & Wealth Management Solutions

The Quarterly Mallard Call

Opportunistic Portfolio Rebalancing

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Readers of this newsletter know that selecting an appropriate asset allocation is critical to ensuring an investor has success in the markets. At the most basic level this is because if an investor chooses a risky allocation such as 80% stock, and can't stomach the volatility when the markets inevitably fall, they will sell at a most inopportune time. At Mallard, we arrive at client asset allocations after evaluating their tolerance for fluctuations (i.e, risk tolerance), their financial capacity to handle fluctuations, and their overall need (or lack thereof) for taking on risk in the first place. Once these variables have been assessed through tools, surveys, and the financial planning process, the asset allocation will be prudently established.

Considering the importance of establishing an appropriate asset allocation, it is then vital to maintain that allocation over time. Because a portfolio's underlying investment holdings produce different returns over time, the portfolio allocation will drift from its target allocation. Unconsciously allowing this to inadvertently occur results in a portfolio with an entirely new risk-and-return profile than originally selected!

Portfolio Rebalancing

Portfolio rebalancing *maintains* the proper asset allocation over time. The basic concept of portfolio rebalancing is to realign the investments in the portfolio to generally stay in line with the originally selected weightings.

For example, let's assume a client has a $1 million portfolio that is split evenly between stocks and bonds. Further, let's also imagine the portfolio has dropped in value to **$950,000** (not hard to imagine). More specifically, as shown in the left side of the table below, the portfolio's stock allocation dropped by 20% (from $500,000 to **$400,000**), while the bond allocation rose by 10% (from $500,000 to **$550,000**).

Due to this portfolio's volatility, the client's current stock allocation is now 42%, while their bond allocation is 58%. Assuming this client purposefully and consciously selected an asset allocation of 50% stocks, should they really be holding a 42% stock allocation after the bear market? It is highly unlikely their risk tolerance, capacity, or need has changed. Worse, imagine a strong stock market rally over the week. **Assuming this client did not rebalance, they will not receive the higher re-**

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Asset	Current Allocation		Change		Ideal Allocation	
Class	$	%	Remove	Add	$	%
Stocks	$400,000	42%		$75,000	$475,000	50%
Bonds	$550,000	58%	($75,000)		$475,000	50%
Total	**$950,000**	**100%**			**$950,000**	**100%**

Notices

Gear Up for Tax Time

Over the next month we will begin the tax preparation process designed to harvest the fruits of tax planning done during the 2018 calendar year. If we prepare your tax returns, you will receive your 2018 Tax Letter and Organizer. Once you have gathered all relevant tax documents, please drop off the information as soon as possible so that we can get started!

Mallard E-Mail Update

Are you receiving our e-mail newsletters (which are different from this quarterly newsletter)? If not, let us know by sending an e-mail requesting to be added to our e-mail newsletter list.

Use ShareFile

When sending confidential information to us, please remember to use the **secure *ShareFile* link** contained at the bottom of each of our email signatures. This link is also located at the top of every page of our website.

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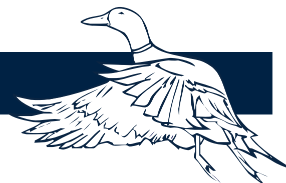


turns that are commensurate with a 50% stock portfolio as they only had a 42% stock portfolio at the time the rally took place!

Now, what must occur to bring this portfolio back to its selected asset allocation? As shown in the table, $75,000 of bonds must be sold in order to buy $75,000 worth of stocks. Only then will the desired asset allocation be reestablished through the process of rebalancing. Imagine for a moment how it would feel to take proceeds from the asset class that has done well (bonds) to buy more of the asset class (stocks) that has been going down the tubes! No doubt this would be a hard trigger to pull, especially considering it must be done at a time when it will feel as if stocks will not recover anytime soon. Rebalancing goes against our very nature and is very hard because when you are supposed to be buying stocks, you will likely be reading some very compelling reasons to sell instead.

Benefits of Portfolio Rebalancing

So far we have touched on two of the benefits of rebalancing. **First** and foremost is the objective of maintaining a desired level of portfolio ***risk*** (and therefore expected return). If you need the expected return that a 50% stock portfolio will provide, but now (after the bear market) you only have a 42% stock portfolio, your expected long-term returns will have dropped from about 6.5% to 6.0%. If you do not rebalance, you are now inadvertently changing your portfolio strategy and results.

The **second** benefit of rebalancing is instilling ***discipline*** in the implementation of your portfolio management. Rebalancing forces us to take money out of precisely those asset classes which have recently been stellar performers, and reinvest it in the asset classes that have of late been deeply out of favor. Rebalancing causes us to act against our own impulse to chase performance. It forces us to systematically sell high in order to buy low. Another way to think about it is that rebalancing compels you to be a contrarian - someone who does the opposite of the crowd. Financial contrarians tend to be wealthier than those who simply run with the emotional herd. Rebalancing is thus the bridge from simple diversification to highly disciplined opportunism. This is exactly the opposite of what most investors do, which in turn explains why most investors underperform not only the markets but their own investments.

This brings us to the **third** and most exciting benefit of portfolio rebalancing: the generation of enhanced risk-adjusted returns as a result of the discipline of buying low and selling high. Rebalancing triggers a sale of the investments that are up the most (because they are over their target weighting due to better relative recent returns) and a buy of the investments that are down the most (because they are under their target weighting due to poor relative recent returns). The value of rebalancing make intuitive sense in that we are continuously taking some profit from the winning investments and reallocating those profits to the losing investments.

Rebalancing exploits the short-term volatility of markets and their tendency to overshoot fair value in both directions, but then eventually revert to their mean. There is a lot of volatility among asset classes, and **rebalancing puts this volatility to work for you.**

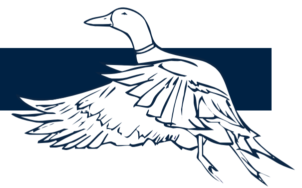
In September 2016, Vanguard determined that portfolio rebalancing potentially adds up to 0.35% in returns when comparing two risk adjusted portfolios where one is rebalanced annually versus the other that is not rebalanced (and thus drifts). Similarly the Envestnet Quantitative Research Group also tackled the value of rebalancing in a white paper entitled “Capital Sigma: The Advisor Advantage” and found value of 0.44%. Regardless of the exact value added through rebalancing, we know it should be positive over time. So, we know that rebalancing is good for us, and good for our results.

Stated most simply, **portfolio rebalancing is designed to instill the discipline we all need in order to maintain our desired portfolio risk/return, while at the same time enhancing returns.**

Implementation

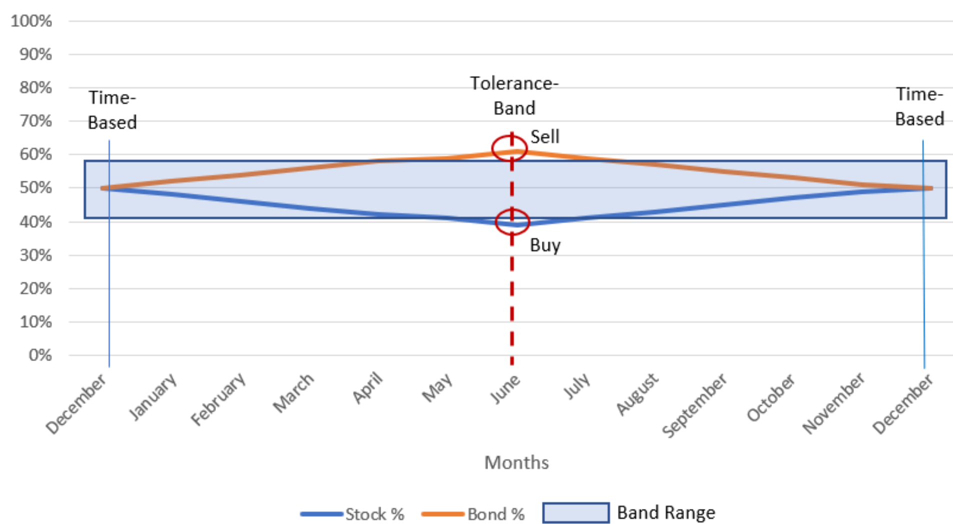
This bring us to the mechanics of implementing a rebalancing program. Portfolio rebalancing may seem simple at first glance. Every year simply sell/buy what is necessary in order to bring your allocations back to their starting point. However, unlike the simple examples above, clients own a multi-asset class portfolio of many different underlying investments (not just “stocks” and “bonds”) that are all bouncing around.

Simply selling/buying each year what is necessary to bring the allocation back to target is a strict **time-based** rebalancing approach which is not optimal. First, it may easily miss opportunities to take advantage of volatility. For example, referring to the visual on the next page, let's say you rebalance every December, but during the year (say in June) one asset class soars while another plummets. However, by year end, they are back to where they started. You then go to rebalance and find there is nothing to be done. However, if you had watched and



rebalanced in June, you would have benefited from the volatility by selling one asset class while it was up, and buying the other while it was down.

The problem with time-based rebalancing is that the dates chosen for rebalancing are arbitrary, and thus you cannot possibly expect to catch the most lucrative buy-low/sell-high opportunities while they are occurring. For example, most time-based rebalancing probably missed the big buy-low opportunities during key events like Brexit (6/23/2016), or the bear market in December 2018. Second, rebalancing right back to your target allocation is too rigid and it increases the total number of trades (and associated costs such as commissions).



Thankfully there is a solution that allows us to both capture the volatility of the uncorrelated asset classes, yet also minimize trading. For most clients, we implement what is known as **recurring tolerance band rebalancing**. This means, rather than rebalancing based upon a time interval, we rebalance based on a target for how "out of band" each asset class (or investment) is allowed to drift before reining it back in again. This is also known as **opportunistic rebalancing** that came out of the research done by Gobind Daryanani (CFP, PhD) in his groundbreaking paper "Opportunistic Rebalancing: A New Paradigm for Wealth Managers" in the *Journal of Financial Planning*.

Think of each investment in your portfolio as a rubber band. Each rubber band has a different thickness, size, and therefore flexibility. We want our investments to stretch a little, but not break. When they do stretch too far on the upside, we sell (high) before they break, and re-allocate the proceeds to the bands that stretched too far on the downside. So, if your stock allocation is supposed to be 50% and your band stretch limit is between 40% and 60%, you only rebalance once the stock allocation exceeds 60% or drops below 40%. This both minimizes trading, but also allows stocks to run a little before taking profits. The other major benefits of using tolerance bands is it allows for frequent "looks" to see if one of your many investments or asset classes has exceeded its band. In a globally diversified portfolio of multiple non-correlated asset classes, it is important to look frequently as one of these assets may fall out of its band as a result of short-term volatility. To catch these transient market moves, your portfolio needs to be checked on an ongoing basis. These frequent looks don't necessarily result in frequent trades, but they do result in identifying and trading an out-of-band investment at an opportune time. In simple terms, **it allows us to more frequently capture the sell high/buy low opportunities.**

As Dr. Daryanani states in his paper, "This "**opportunistic rebalancing**" approach not only controls portfolio risk but also provides significant return improvements by capturing sporadic buy-low/sell-high opportunities as asset classes drift relative to each other. **We will show that, with frequent looking, rebalancing return benefits are significantly improved compared with traditional quarterly or annual rebalancing.** For example, by looking frequently but rebalancing only when needed, the average rebalancing benefits are shown to be more than double the benefits of more traditional annual rebalancing."

In summary, opportunistic rebalancing is designed to instill the discipline needed in order to maintain our desired portfolio risk/return, while at the same time enhancing our portfolio returns.

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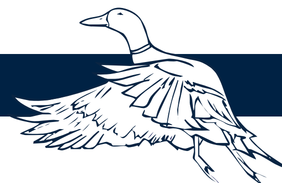
Market Commentary



This was the year the long, seemingly endless bull market came to a crashing halt--and U.S. investors finally, for the first time since 2008, experienced the normal definition of a bear market (down 20% from the S&P 500's all-time high on September 20).

2018 was also a year of disconnect between economic metrics and stock returns. On the one hand, it was a great year for the economy. In fact, it is almost impossible to cite all the major metrics of the economy which blazed ahead in 2018 - worker productivity, wage growth, employment, household debt, etc.

But the equity market had other things on its mind. Having gone straight up without a correction throughout 2017, the S&P 500 came roaring into 2018 - probably somewhat ahead of itself, as it seemed to be discounting the entire future effect of corporate tax cuts in one gulp. There ensued in February a 10% correction, followed by several months of retracement. The advance resumed as summer waned, with the Index reaching a new all-time high of late September. It then gave way to a fast decline, falling to the threshold of bear market territory on Christmas Eve, off 19.8% from the September high.

A rally in the last week of trading was too late and too little ending the year with a 4.5% decline for large U.S. stocks (as represented by the ***Vanguard 500 Index Inv***). See the table below for all major asset class returns over the last year. 2018 became the tenth year of the last 39 (beginning with 1980) in which the stock market closed lower than where it began. At the long-term historical rate of one down year in four, that's actually just par for the course.

Nobody can predict whether the markets will recover in 2019 or experience a steeper decline for the simple reason that the stock market can be largely driven by emotions during a downturn. Crowd psychology can bring about these types of situations, even when the fundamentals wouldn't seem to warrant such an event. All we know is that, historically, all bear markets in history have been temporary phenomena, and that investors who don't change their investment plan in the middle of a bear market, but instead rebalance their portfolios will very likely do much better than investors who lose their nerve and sell in a panic during the downturn. As the wise and witty Sage of Omaha wrote in his 1994 shareholder letter, "Fear is the foe of the faddist, but the friend of the fundamentalist."

Total Returns as of 12/31/2018

	Month	Qtr	12 Mos	*Annualized* 3 Years	*Annualized* 5 Years
GLOBALLY DIVERSIFIED BALANCED PORTFOLIO**					
60% Equity / 40% Bond	(5.0%)	(8.8%)	(6.4%)	5.2%	3.5%
STOCKS					
Larger-Cap	(9.0%)	(13.6%)	(4.5%)	9.1%	8.3%
Smaller-Cap	(11.1%)	(11.4%)	(9.4%)	7.5%	5.1%
International - Developed Mkts	(4.9%)	(11.7%)	(14.4%)	4.5%	0.9%
International - Emerging Mkts	(3.0%)	(6.3%)	(14.7%)	7.6%	1.2%
Real Estate	(8.0%)	(6.5%)	(6.1%)	2.2%	7.2%
Inflation Hedges*	(7.9%)	(17.9%)	(19.0%)	6.2%	(3.2%)
BONDS					
U.S. Investment Grade Bonds	1.8%	1.6%	(0.1%)	1.9%	2.4%
Global Bonds	1.2%	1.8%	3.0%	3.4%	4.0%

** Each asset class is represented by a relevant Vanguard Index fund except for Inflation Hedges where the Morningstar Category average for* ***"Natural Resources"*** *is used.*

*** The portfolio is represented by the DFA Global Allocation Fund (60% Equity / 40% Bond) - DGSIX*