EVERGREEN ESSENTIALS

REBALANCING

What is Rebalancing?

Rebalancing helps investors manage risk in their portfolios, by preventing portfolios from becoming too concentrated.

When portfolios are originally built, investors often set target weights for each asset, so that the portfolio is well-diversified and represents investor views with respect to both risk and, hopefully, return. Over time, those weightings will change as assets perform differently.

Rebalancing is essentially the process of ensuring that assets continue to be held at their target weight in a portfolio, so that the overall risk in the portfolio remains in check.

Why Investors Rebalance

Consider the example of an investor with a portfolio containing an Equity ETF and a Bond ETF, with target weights of 50% each. If the Equity ETF grows more than Bond ETF over a month, it will become a larger percentage of the portfolio by the end of the month.

To realign this portfolio with the target, the investor must sell units of the Equity ETF and buy units of the Bond ETF. If the investor doesn't rebalance, and the Equity ETF were to grow significantly more than the Bond ETF, it would become a much larger proportion of the portfolio. Over time, the portfolio's performance will become more tied to that of the Equity ETF and the whole portfolio will become more volatile as a result.

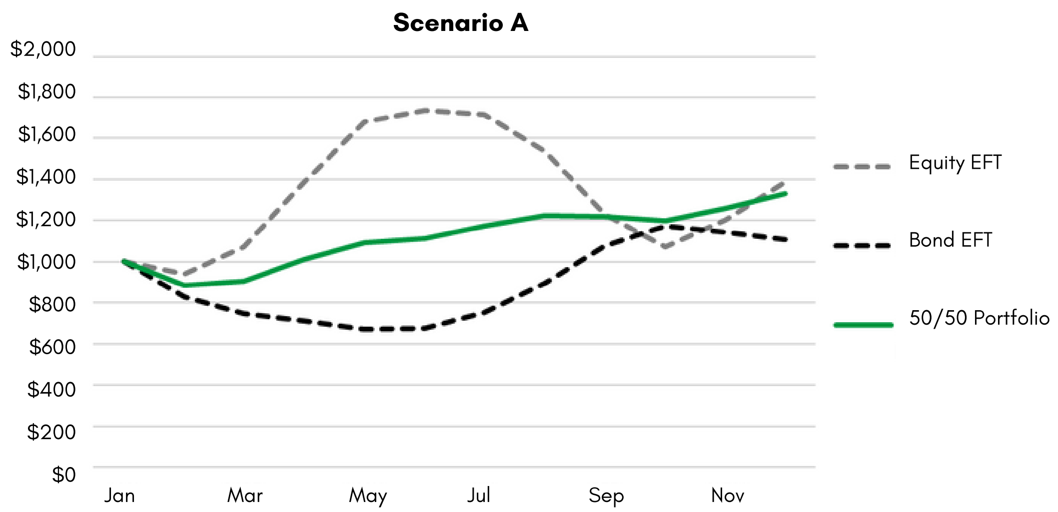
In this case, rebalancing ensures the portfolio risk levels remain at the right level over time.

Regular rebalancing can lead to greater performance as well. This is generally the case when the assets in the portfolio are volatile and perform well at different times. If the assets are volatile enough, it is possible for the diversified portfolio to outperform even its best performing component.

To visualise this, we have the 50/50 portfolio of an Equity ETF and a Bond ETF, rebalanced monthly. Our first scenario is of a volatile bull market over 12 months.

SCENARIO A

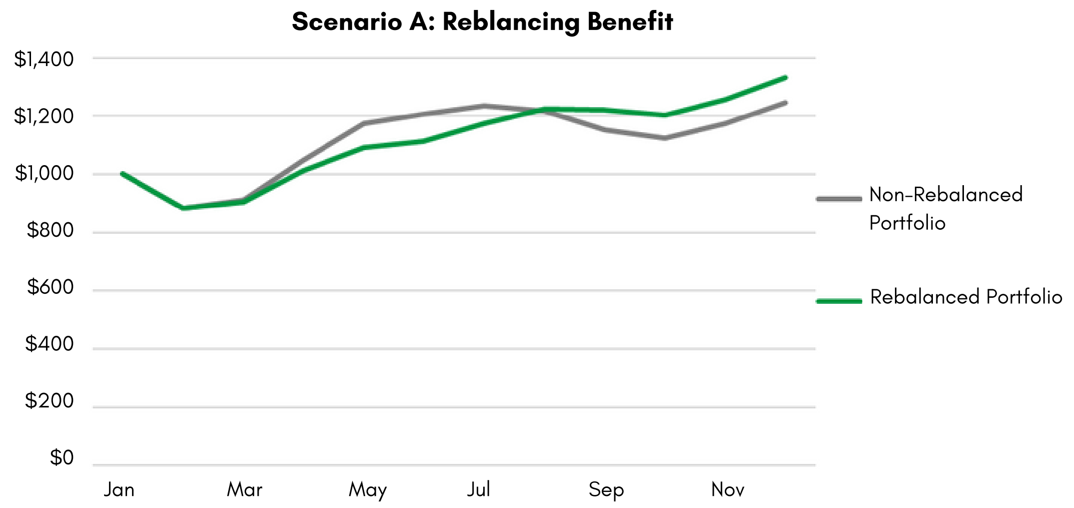
MONTH	EQUITY ETF	BOND ETF	50/50 PORTFOLIO	NON-REBALANCED PORTFOLIO
JAN	$1,000	$1,000	$1,000	$1,000
FEB	$940	$828	$884	$884
MAR	$1,074	$750	$905	$912
APR	$1,387	$710	$1,013	$1,049
MAY	$1,678	$670	$1,091	$1,174
JUN	$1,735	$676	$1,114	$1,206
JUL	$1,714	$755	$1,173	$1,234
AUG	$1,540	$896	$1,223	$1,218
SEP	$1,228	$1,075	$1,221	$1,152
OCT	$1,073	$1,176	$1,202	$1,125
NOV	$1,204	$1,144	$1,258	$1,174
DEC	$1,384	$1,108	$1,333	$1,246



In Scenario A, both ETFs deliver strong returns but due to their volatility, the Rebalanced Portfolio outperforms both.

The value of the portfolio without rebalancing will always be halfway between the value of the two ETFs and in this case, neither would not have performed as well.

The Rebalanced Portfolio is compared to the Non-Rebalanced Portfolio below.

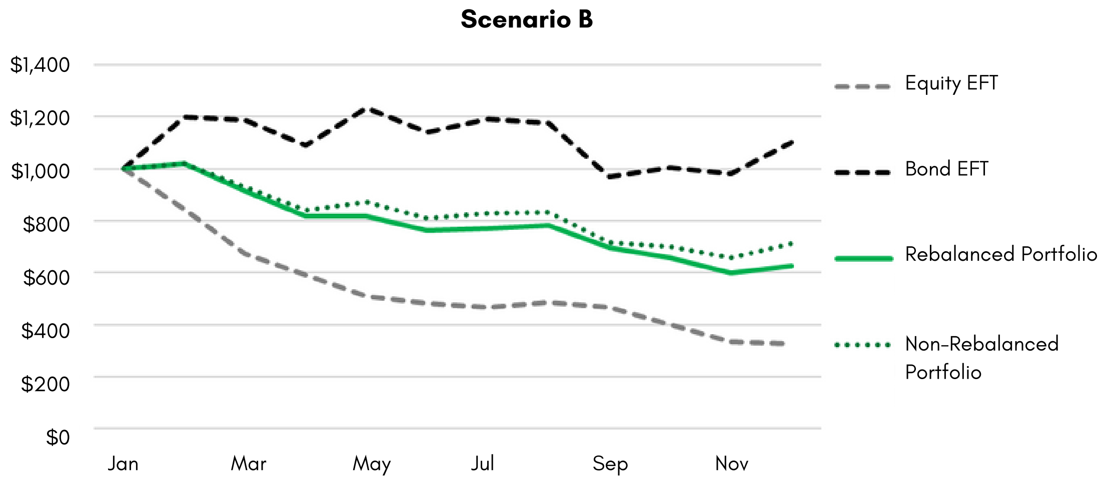


There are circumstances when the portfolio performance doesn't benefit from rebalancing.

Below is one such example, where one ETF consistently outperforms the other, and there is less volatility.

SCENARIO B

MONTH	EQUITY ETF	BOND ETF	50/50 PORTFOLIO	NON-REBALANCED PORTFOLIO
JAN	$1,000	$1,000	$1,000	$1,000
FEB	$844	$1,198	$1,021	$1,021
MAR	$675	$1,187	$914	$931
APR	$590	$1,089	$819	$840
MAY	$511	$1,235	$819	$873
JUN	$481	$1,140	$763	$811
JUL	$466	$1,193	$769	$830
AUG	$488	$1,175	$782	$832
SEP	$465	$970	$695	$718
OCT	$399	$1,006	$658	$702
NOV	$336	$981	$598	$658
DEC	$325	$1,102	$626	$714



In Scenario B, the Rebalanced Portfolio underperforms the Non-Rebalanced Portfolio.

It may be tempting to allow the best performing asset to grow and become a larger proportion of the portfolio, as it has in this example. However, risk does become concentrated as the position grows.

As past performance doesn't determine future performance, and each asset carries its own risks, this could lead to problems as the portfolio becomes more concentrated in one asset.

Things to Note

Rebalancing isn't always free.

This is because it involves selling assets that have performed relatively well and buying assets that have performed less well. So, there could be capital gains tax and transaction fees.

The Takeaway

Rebalancing is a simple and effective way to manage risk in your portfolio, but your tax rate and transaction fees will determine how costly rebalancing is for you.

Ultimately you should discuss rebalancing along with your situation and needs with your Financial Adviser, to ensure your strategy suits you and your financial needs.