INVESTOR

Russell Investments

The Rebalancing Reward

Helping you make informed investing decisions.

russellinvestments.com/ca

A successful investment strategy begins with an asset mix designed to fit your personal goals and preferences. When done right, it has the potential to provide the highest expected risk-adjusted return consistent with your risk tolerance.

But the capital markets can move in unexpected ways, and that means your investments can sometimes move away from the original asset allocation. A rally in equities, for example, could cause your portfolio to become overweight in that asset class. That in turn means your risk/return ratio could get out of whack – potentially jeopardizing the investment outcome you want your portfolio to provide.

Regularly rebalancing your portfolio can potentially keep it on target, and can help reduce unintended risks from volatile capital markets.

Why rebalancing is necessary

Rebalancing reduces the risk of your portfolio becoming concentrated in one asset class to the detriment of others. Without rebalancing, the percentage of your portfolio allocated to an asset class that has outperformed (U.S. equities, for example) can increase well beyond your targeted allocation, while the percentage of your portfolio allocated to an asset class that has underperformed (such as domestic bonds), can shrink below your targeted allocation.

Remember, your asset mix was carefully selected to fit your desired outcome and tolerance for movements in the value of your investments. If your portfolio becomes top-heavy in equities, it can become more vulnerable to volatile changes in the market. And if the allocation to bonds – which tend to act as a stabilizing force in a portfolio – gets too small for your risk tolerance, then you face the possibility of not meeting your targeted outcome.

How rebalancing works

When you rebalance, you trim back "winning" assets and increase undervalued assets. Essentially, you are buying low and selling high – a guiding principle of investing. Suppose you began with an asset mix of 60% equities and 40% fixed income, but market growth took your allocation to 72% equities and 28% fixed income. Rebalancing back to your original mix would allow you to lock in those gains from equities, and buy fixed income assets at a relatively lower price. This may be hard to do without a systematic rebalancing policy: after all, it is human nature to want to hang on to winners and sell losers. Rebalancing ensures you don't let your emotions guide your investments.

According to the results in the table below, regularly rebalancing a portfolio will give you a better risk-adjusted return to that of a non-rebalanced portfolio.

Figure 1: A Comparison of Rebalancing Strategies: (Dec. 1979 - Dec. 2017)

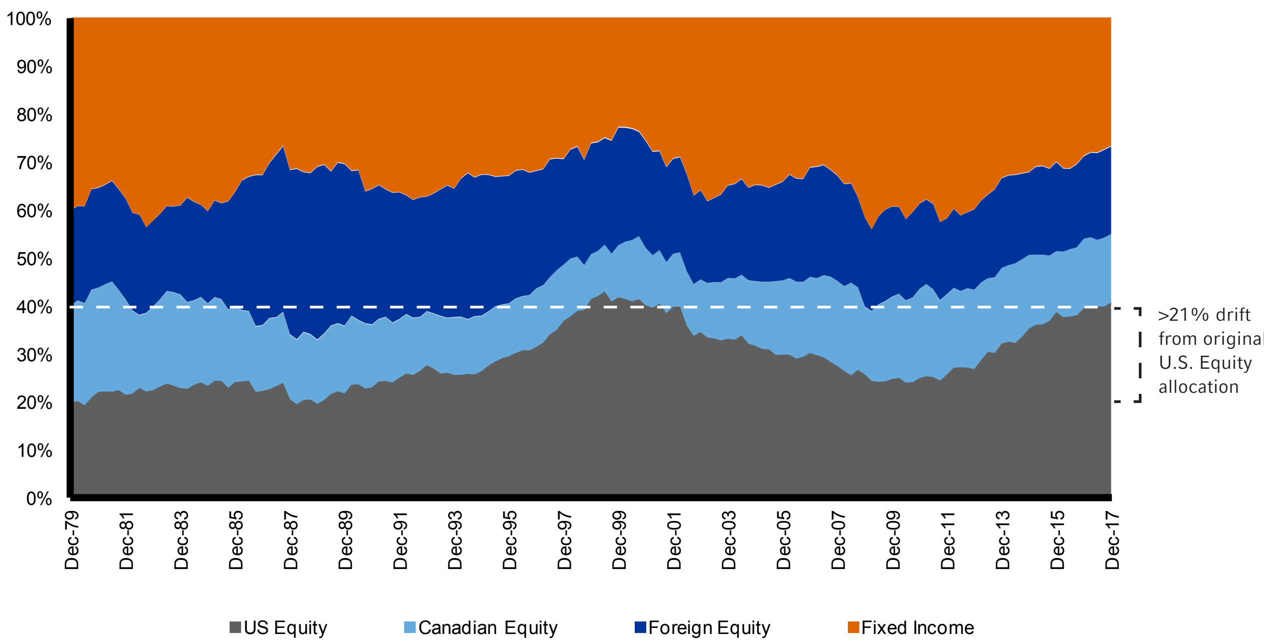
REBALANCING TYPE	BUY AND HOLD	SYSTEMIC REBALANCING
Return	9.9%	10.1%
Risk	10.3%	9.6%

Source: Russell Investments Canada Limited. Original Portfolio Asset Mix: 40% Fixed Income (FTSE TMX Canada Universe Bond Index), 20% Canadian Equity (S&P/TSX Composite Index), 20% US Equity (S&P 500 Index), 20% Foreign Equity (MSCI EAFE Index). Indexes are unmanaged and cannot be invested in directly. Returns represent past performance, are not a guarantee of future performance, and are not indicative of any specific investment.

The Cost of Rebalancing

Despite the obvious benefits of rebalancing, there are transaction costs and tax consequences, so you should speak to your advisor before implementing a rebalancing strategy. Tax consequences are an issue for investors in non-registered portfolios. For example, if you have a sizable unrealized capital gain, you may want to wait until you have a tax loss you can use to offset it. The common-sense solution to this issue is that whenever possible, you should use new cash flow to bring your portfolio back to its target asset mix. This is easily done through a periodic PAC (pre-authorized contribution) plan—which provides on-going regular contributions to your portfolio and does not trigger any taxable consequences.

Figure 2: Asset Allocation drift of a hypothetical diversified portfolio December 1979 - December 2017, with no rebalancing



Portfolio returns based on a diversified portfolio consisting of : 40% Fixed Income (FTSE TMX Canada Universe Bond Index), 20% Canadian Equity (S&P/TSX Composite Index), 20% US Equity (S&P 500 Index), 20% Foreign Equity (MSCI EAFE Index). Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.

The rewards of rebalancing

As financial markets fluctuate and investment climates change, investors need a strategy that can weather these changes and still provide a solid opportunity to achieve their goals.

Without a rebalancing strategy, you could end up with a portfolio that is significantly out of line from your initial risk and return objectives. Rebalancing can help you stay within your comfort zone.

Russell Investments

INVESTOR is published quarterly by Russell Investments.
Please direct comments or questions to your financial advisor.

russellinvestments.com/ca

Date of first publication: October 2018

RETAIL-02327 [EXP-10-2020]