The Great Rebalancing Catastrophe

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For decades the de rigueur strategy for asset allocation decisions was the utilization of the concept of rebalancing. For example, if a portfolio was structured to hold a 40% position in stocks and a 60% position in bonds, the manager would offset an increase in the value of stocks and a decrease in the value of bonds due to market conditions by selling stocks and buying bonds until the portfolio was back in "balance" i.e., 40% position in stocks and 60% in bonds. Studies had shown that systematic rebalancing would add value to a portfolio over time as the bonds would provide reasonable income while lowering the volatility inherent in a stock portfolio. In the Seventies and Eighties who could argue with a bond coupon of 8-12%!

The problem with this strategy is that it has not held up well during a record bull market in stocks and a long-term collapse in bond yields. For years, bond portfolio returns were more than respectable on paper with falling yields offset by rising bond prices. In some years, bond returns exceeded stock returns! Investors not only had stability from bonds and a reasonable income return but also an attractive total return. Meanwhile volatility in the stock market left shareholders with little if any return during the volatile 2000s.

These favorable metrics that enhanced the viability of rebalancing began to change after the stock market crash of 2008-2009. The Federal Reserve's new policy of keeping interest rates low reduced the income returns from bonds although some calculations of capital gains on bonds was a short-term palliative. In the meantime, the stock market began an historic run with a combination of higher stock prices and rising dividends. As the 21st century entered its third decade, the outlook for bond returns was terrible but rebalancing continued to pour trillions of dollars into bonds and bond funds while much of the record gains in stocks were being lost to rebalancing as asset allocation strategy

At this point, bonds have reached a dead end when it comes to bolstering the returns of an asset allocation portfolio. As stocks continue to set records, asset allocators keep selling stocks and buying bonds that have very little attraction as a long-term asset for fulfilling the needs of retirees. In many cases, investment grade bond yields are yielding less than inflation. The outlook for future bond yields remains low given the Fed's intentions of not raising interest rates. Even if the Fed relented and let rates begin to rise, current bond portfolios would suffer as old bonds would fall in price and produce lower total return making bonds even less attractive.

The sad news is that many, if not all the Target Date fund strategies incorporate this rebalancing strategy. As investors age, these funds buy more bonds and sell stocks. While such a strategy lowers portfolio volatility, rebalancing is likely to produce a much lower rate of return over time. One of the big fears of retirees is that they will run out of money in retirement. As interest rates remain low, a strong stock market will be their only savior.

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