The Rebalancing Nightmare

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We are not proponents of rebalancing due to the fact that the whole idea of selling winners and buying losers makes little sense especially during a bull market in stocks. This strategy only works if the markets move in a directionless short-term saw-toothed pattern, yet this movement seldom happens. During an extended bull market in stocks such as the 1995-1999 surge and the more recent 2009-2019, investors who continually sold their stocks, and bought bonds found their portfolios underperforming. Another important consideration in moving money into bonds is the changing nature of the fixed income market. Historical studies of bond returns can be misleading. From the peak in interest rates on long term bonds in the early 1980s when yields were over 14% today these same bonds yield near 3% or lower! This difference undermines the validity of generating long-term returns on a bond portfolio. With increasing fixed income exposure in retirement portfolios where yields are substantially lower than over the last 40 years, those portfolios cannot achieve the returns often reflected in the historical analysis of returns.

This reality does not seem to affect target date funds. These supposed long-term retirement vehicles have a built-in rebalancing strategy that is driven by a terminal point in time. The strategy gradually reduces the stock allocation in a portfolio in favor of bonds. At age 65, a theoretical retirement age, the portfolios drop to about a 30% stock weighting even though the average life expectancy of these retirees is near 90 and increasing! Given the long-term history of stock returns that average over 10% and current bond yields of about 3-4%, you can see that an ever-growing bond position lowers the size of the retirement portfolio and increases the chances that the investor could run out of money during their lifetime.

But do not take our word for it. A recent research paper published by the National Bureau of Economic Research questioned the validity of the target date strategy for retirement savers. “The typical glide path used by target-date funds is too conservative starting at age 50. In contrast to an equity exposure level that drops to 50% by retirement age and to as low as 30% during retirement, the average recommended equity exposure in the researchers’ model never falls below 60%.” The author of the paper, Professor Jonathan Parker, does not knock target date funds although he says they are a lot better than what existed before their creation. He concluded that “we can do a lot better. It can’t be optimal to be average.”

Rebalancing can also affect financial markets as more firms adopt this strategy. After one quarter of unusual performance for an asset class, the model for rebalancing sells the outperforming asset and buys the underperforming one. Early in 2022, rebalancing caused a selloff in growth stocks and a rally in value stocks as portfolio managers rebalanced. These mechanical events can distort markets and increase volatility. This outcome can only get worse as more assets get systematically rebalanced. This is one reason why we never rebalance.