Dimensional

March 1, 2010

# A Question of Balance

**Jim Parker**, Outside the Flags
Vice President



We humans tend to prefer avoiding losses than securing gains. That's why volatile financial markets make us feel so anxious. Helping us to find a balance amid these natural emotions is the mark of a good advisor.

To understand the value of good advice, it helps to reflect on the cost of bad advice. And that has been clearly evident in recent years as millions of people were pushed into strategies incompatible with their needs and risk appetites.

Bad advice means pandering to human emotions by exploiting greed and fear. It means pursuing high returns in the good times with little attention to risk and fleeing from risk in the bad times with no regard for return.

*Good* advice means taking the emotions out of the equation and showing us what we can and can't control. We *can't* control the ups and downs of financial markets. We *can* control the risk in our portfolios through broad diversification, astute asset allocation and regular rebalancing.

Just having a detailed plan designed for our own risk appetites, lifestyle needs and long-term goals goes a long way to removing the anxiety from the investment process. During volatile markets, knowing that we have a diversified portfolio helps manage our personal tolerance for risk.

Bad advice panders to the view that the best way to invest is to attempt to time our entry and exit points. We are either *in* or *out* of the market. Getting that decision right, however, is notoriously difficult — even more so these past two years when risk assets undertook a complete u-turn.

By contrast, good advice stresses the virtues of discipline and patience. And that doesn't mean blindly sticking to a buy-and-hold strategy.

Regular portfolio rebalancing actually gives investors control over the risk in their portfolios. After a run-up in riskier assets, they can legitimately sell down the stronger performing asset classes and rotate into the poorer performers to bring their own intended asset allocation back on track.

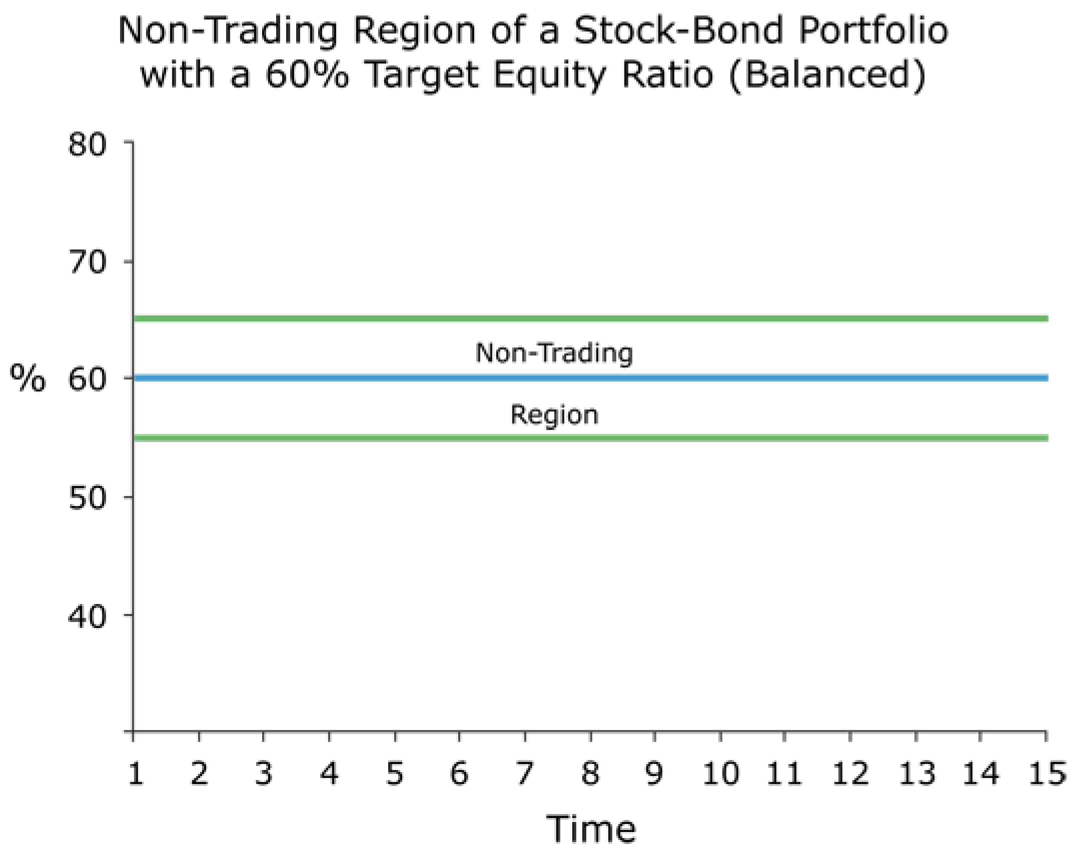
Another way of looking at this rebalancing process is that the investor is selling high and buying low. This isn't a timing strategy, by the way, but a means of managing portfolio risk so the investor sticks to the original plan.

The absence of regular rebalancing was evident during the financial crisis when many investors found their portfolios had drifted out to the frontiers of risk without their knowledge or consent. The consequences for their long-term wealth in many cases were disastrous.

But just as a lack of rebalancing can throw a portfolio out of whack and undermine the targets of the original financial plan, too frequent rebalancing can be costly. These costs include fixed costs such as administrative charges and potential platform costs, alongside proportional costs such as buy/sell spreads, broker commissions and capital gains taxes.

So the decision for advisors about when to rebalance often comes down to a question of balancing the benefits of keeping the portfolio within the investor's risk profile against the costs of changing the asset allocation. This decision is as much an art as a science. As such, there is no one 'right' answer and the issue often can be dealt with by creating a 'hold' range within the portfolio.

The example in this graphic uses a balanced portfolio with a target ratio of 60% equities. In this case, the advisor has decided to allow a 5% buffer either side of this target to achieve a practical equilibrium between the need to maintain the broad asset allocation while minimising costs.




Aside from setting a non-trading region, another consideration in rebalancing is to use natural cash flows from regular contributions by the investor and cash distributions. That way the advisor reduces the need to sell securities, thus avoiding some of the costs of rebalancing.

Unlike the actual movement of markets, all these decisions are within the control of advisors and their clients. The result is the maintenance of a financial plan that the investor can live with in the best of times, the worst of times and all the bits in between.

Markets are unpredictable. We can't change that. But we can build an asset allocation that successfully builds a bridge between our own tolerance for volatility and our long-term investment goals.

With occasionally rebalancing to ensure the asset allocation continues to match our risk profiles, we can sleep better at night.

That is the value of good advice.