SAVVY INVESTING

THE PORTFOLIO BALANCING ACT

WINTRUST WEALTH MANAGEMENT

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Investment success begins with a sound asset allocation that matches an investor's financial goals and tolerance for risk. Asset allocation—the prescription of the mix of stocks, bonds, and other asset classes in a portfolio—has been shown to be by far the most important factor in long-term investment performance.[1] However, it is a dynamic process. If history teaches us anything, it is that the only certainty in the financial markets is change. Over time, market forces will alter the composition of a portfolio that can increase risk, lower returns, and otherwise adversely affect how well it matches the investor's financial goals and risk tolerance.

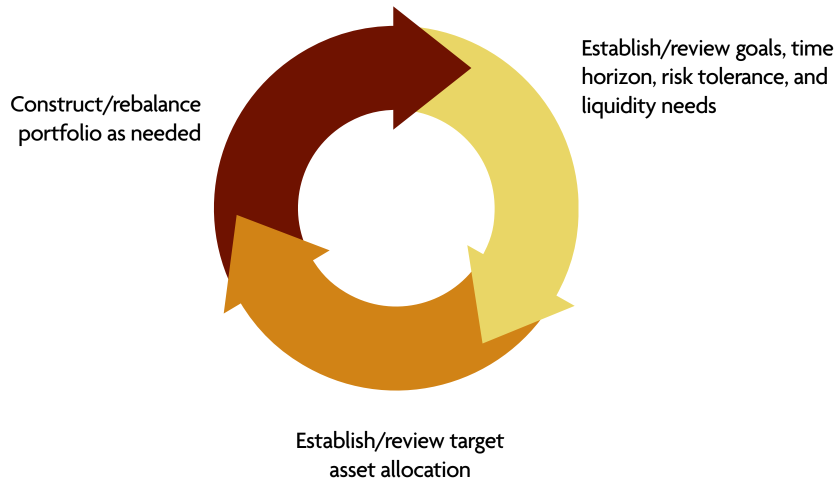
Wise investors regularly monitor their portfolios rather than let their portfolios drift with the prevailing currents, and review their target allocations to determine if they are still appropriate. They also have procedures in place to guide decisions around when and how to adjust their portfolios accordingly. This process is known as rebalancing and it is a critical and often misunderstood aspect of the investment management cycle.

Portfolio rebalancing is a powerful risk-control mechanism that can also actually improve returns in certain market cycles over time. It provides a number of important benefits. First and foremost is that it reduces risk and can mitigate the severity of losses in times of poorly performing markets. It also helps remove emotions from investing by establishing a disciplined process that guards against the temptation of chasing hot markets or market timing.

Furthermore, a rebalancing strategy provides for a regular review not just of the portfolio's construct, but of the investor's goals, needs, time horizon, and risk tolerance to determine if target asset allocation levels need refinement. An investor's time horizon grows shorter each year, and as such, the most appropriate target asset allocation will gradually change over time as well.

Finally, while the primary benefit is risk reduction, a sound rebalancing strategy will also tend

The Investment Management Cycle



to improve returns in the long-run. In part, this is because the rebalancing process is inherently contrarian as it forces investors to sell assets that have appreciated and buy assets that are temporarily out of favor. In general, a rebalanced portfolio should produce higher absolute returns when the return differences among asset classes are relatively low, market volatility is relatively high, and the degree to which returns on different asset classes track each other (referred to as their correlations) are low.

A POWERFUL INVESTING STRATEGY

In today's markets, rebalancing is especially important. In a recent interview, Burton Malkiel, the famed economist and author of the investing classic *A Random Walk Down Wall Street* noted: "Individuals take money out of the market at exactly the wrong time, and put money in at the wrong time. In very volatile markets such as we have had, and such as I suspect we are likely to have in the future, there is just an enormous advantage in rebalancing because it always reduces risk and in very volatile markets will actually increase returns."

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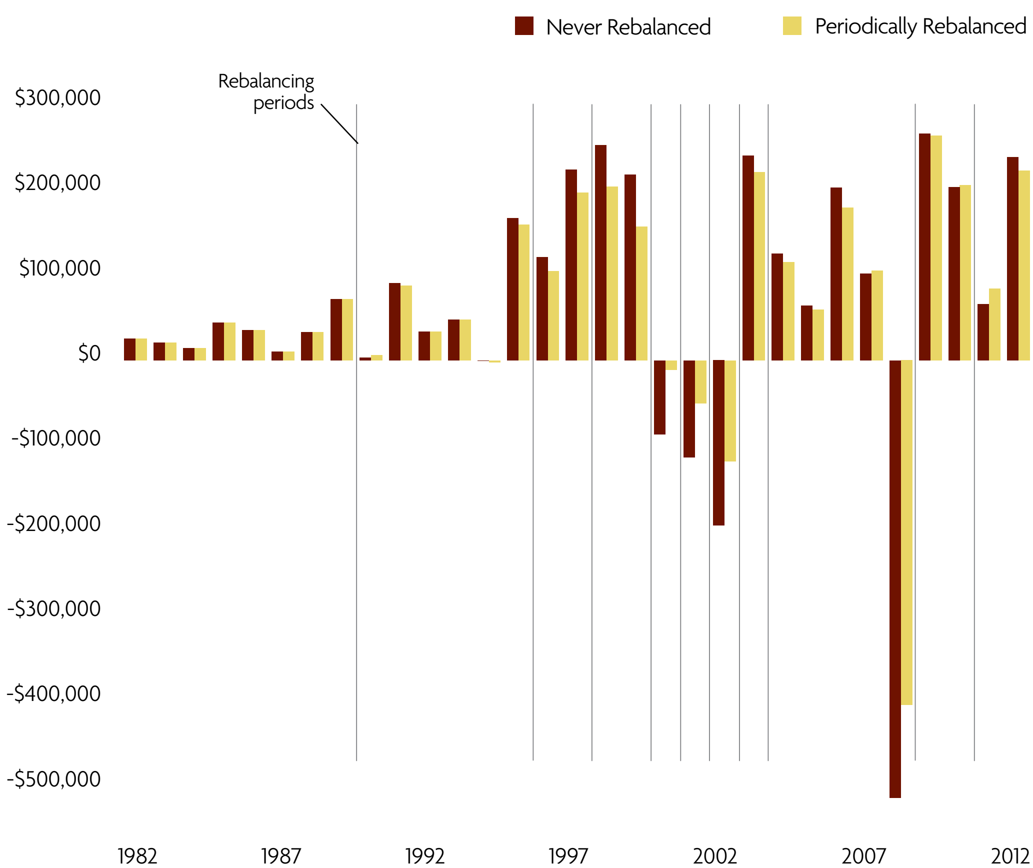
To illustrate the point by way of example, consider two separate $100,000 portfolios invested in 1982 in 60% stocks and 40% bonds.[2] One portfolio is left unattended through the end of last year, while the other is rebalanced at year-end whenever the asset allocation drifts beyond 5% either way of the original 60/40 mix of stocks and bonds. As the chart below shows, the unattended portfolio was considerably more volatile. In fact, it was 16% more risky than the rebalanced portfolio.[3] While this additional risk did result in better gains for the unattended portfolio in good years for the stock market, the $268,848 gain produced in the best year (up 31.5% in 1995) was only $2,361 more than the managed portfolio produced. On the other hand, the worst year (down

Rebalancing Reduces Risks and Can Improve Returns[2,3]

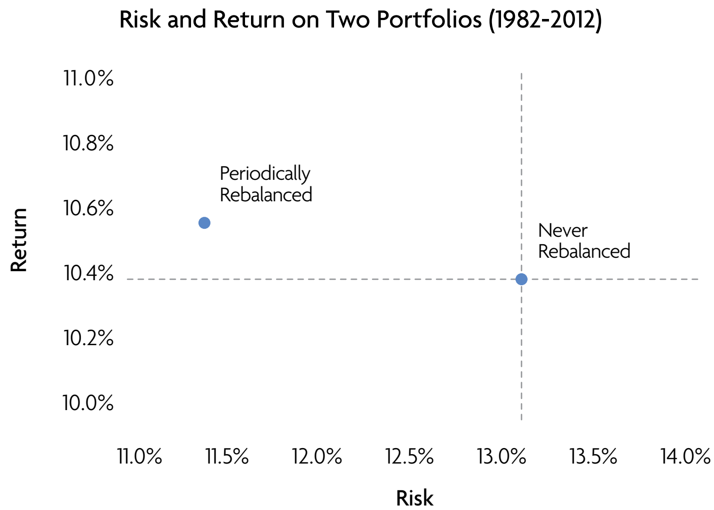
Annual Gains/Losses From a $100,000 Portfolio



27.7% in 2008) resulted in a $518,159 loss which was $110,000 more than for the managed portfolio. Consequently, the rebalanced portfolio was not only less risky, but it actually produced better total return, as shown in the chart to the right.

The rebalanced portfolio's 10.56% average annual return resulted in a value of $2.24 million before taxes at the end of 2012—$111,000 more than the unattended portfolio which produced an average annual return of 10.38%.[4]

The Rewards of Rebalancing[4]



DANGEROUS TEMPTATIONS

Clearly there are benefits to having a regular review and rebalance plan. It should be part of every investor's ongoing financial management plan. Yet, many often ignore this important process and allow their portfolios to run unchecked for long periods of time. In a recent survey of American investors approaching retirement, 20% of respondents said they had not rebalanced their portfolios in at least five years or did not know when they had last rebalanced and an additional 9% had actually never rebalanced.[5] This neglect is especially common with 401(k) plans. A survey of almost 1,200 investors by the Investment Company Institute found that only 25% had made any changes in the allocation of their 401(k) balances since first enrolling in their plans.

"I haven't looked at my investments in a while. I'm a 'buy-and-hold' investor."

In the parlance of economists who study financial behavior, this is known as the "status quo bias." Left to their own devices, investors tend to ignore their portfolios, often out of a perception that change is dangerous. By trying to avoid risk, however, investors often end up increasing risk as illustrated previously.

"The market is up and my portfolio is doing well—I'll just leave it alone and let it run."

Understandably, during highly volatile markets such as experienced during the financial crisis beginning in 2008 or the bubble collapse in the early 2000s, the idea of rebalancing may seem counter-intuitive—selling their better-performing assets and buying underperforming asset classes. Many investors are lured into the trap of acting on emotional impulses, thinking: "A market correction is coming, so I should sell" or "The markets are too choppy, I just want to hold and ride it out." However, throughout investing history, significant rebalancing opportunities into equities have occurred after strongly negative market events.

"I think a market correction is coming—I'm selling stocks."

Times of distress in the equity markets are not the only times that investors are reluctant to rebalance. Despite a loss aversion tendency, many investors are equally loath to rebalance during bull markets for equities. In these times it is tempting to think "The market is up and I'm doing well—I'll just leave it alone and let it run." Similarly, however, these investors unwittingly allow their portfolios to assume excess risk and almost invariably suffer poorer performance as a result.

"The markets are too choppy—I'm going to just hold my positions and ride it out."

THE ART OF REBALANCING

There are many established approaches to rebalancing, though most of these fall into one of three basic types. The simplest of these is periodic rebalancing. In this approach, portfolios are reset to their target allocations on a fixed schedule, such as monthly, quarterly, or annually, regardless of how much or how little the portfolio's asset allocation has drifted. This method has the appeal of simplicity, but can result in many minor adjustments that may produce more expense than their benefit justify depending on the set frequency of rebalancing. A comprehensive study by Vanguard concluded that risk-adjusted returns are not meaningfully different whether a portfolio is rebalanced monthly, quarterly or annually; however, taxes and transaction costs suggest that annual or semiannual monitoring is most effective.[6]

For most broadly diversified stock and bond portfolios, annual or semiannual rebalancing at 5% thresholds produces the best balance between risk control, performance, and cost.

The second type of approach is known as threshold rebalancing. Here, portfolios are adjusted whenever a particular asset class deviates from its target allotment by a predetermined amount, such as plus or minus 5 percentage points, regardless of the amount of time that has passed since the last rebalancing. This is clearly a more flexible approach than periodic rebalancing, but it requires daily monitoring and in volatile markets can trigger a great deal of unnecessary trading depending on the threshold level prescribed.

The third type of rebalancing combines the two approaches. This method calls for rebalancing the portfolio on a periodic basis but only if the asset allocation has drifted from its target level by a predetermined amount. Vanguard's previously cited study concluded that for most broadly diversified stock and bond portfolios, annual or semiannual rebalancing at 5% thresholds produced the best balance between risk control, performance, and cost.[7]

FURTHER CONSIDERATIONS

In addition to selecting a rebalancing approach, there are a number of equally important matters to consider both in general terms and in the current investment environment:

Rebalance in the context of all invested assets

Rebalancing a single portfolio that only includes a portion of an investor's assets is an exercise in shortsightedness. Liquid investment portfolios, IRAs and 401(k)s must all be considered in totality by an investor to ensure that the collective risk assumed by all investments across all accounts is aligned with the investor's risk tolerance, return goals, time horizon, and liquidity needs. Doing so only within a specific investment account will produce limited results.

Taxes and transaction costs matter

The benefits of rebalancing can be significant but must be considered in light of the tax and transaction costs. When possible, rebalancing should be done with new contributions or the portfolio's cash flows such as dividends, interest payments, and realized capital gains. In addition, unrealized gains and losses associated with securities in a portfolio should be considered carefully before transactions are executed, as should the prospective future performance of those securities—matters best addressed by a seasoned investment professional.

Prepare for potential future market conditions

No one knows what the future holds for the markets; however, change is inevitable and it is prudent to consider how best to position a portfolio to react to what may lay on the horizon. In today's markets, the prospect of interest rates rising from their historically low levels poses a serious threat.

Since 2009, the Federal Funds target rate has been held at 0% to 0.25%. Furthermore, yields on fixed income investments have been artificially deflated by the Federal Reserve's monetary stimulus programs of the past several years. The Federal Reserve has vowed to continue its stimulus efforts—and hence keep rates low—until U.S. economic growth is self-sustaining. With the economy steadily improving, the question then is not if, but when, the Fed stimulus will end and interest rates will begin to rise. The potential for rising rates poses a significant threat to fixed income investments as the value of these investments falls as rates rise. In these market conditions, it may be advantageous to consider alternatives to traditional fixed income when rebalancing.

From dividend-paying stocks, to laddered bond portfolios and Unit Investment Trusts, there are numerous means of insulating against the risk of rising rates while seeking fixed income streams. For more information and investing ideas, we encourage investors to meet with one of our Financial Advisors and read our publication, *Investing in a Rising Rate Environment*.

> "The untended garden is soon overgrown with weeds."
>
> ***-Anonymous***

YOUR PORTFOLIO BALANCING ACT

Just as there is no universally optimal asset allocation, there is no universally optimal rebalancing strategy. However, leaving your investments to chance is, as noted previously, is dangerous. It is akin to leaving a toddler alone in a room with a hot stove. The outcome depends far too much on sheer chance. We encourage investors to work with a professional advisor to devise and implement a strategy that is right for them. The investment professionals at Wintrust Wealth Management can help you put in place an investment management process that is appropriate for you.

With stocks on a four-year bull run and the threat that potentially rising interest rates pose to bonds, now may be a good time for investors to review their portfolios to ensure their asset allocation is still appropriate and to put into place a rebalancing plan for the future. Doing so could mean the difference between retaining your hard-earned profits and losing them to the next market cycle.

1. Brinson, Hood, and Beebower (1986); Brinson, Singer, and Beebower (1991); Ibbotson and Kaplan (2000); and Davis, Kinniry, and Sheay (2007).
2. Stocks are represented by the S&P 500 Index and bonds are represented by the Barclays U.S. Aggregate Bond Index.
3. 13.13% standard deviation of annual returns of unattended portfolio compared to 11.36% standard deviation for the rebalanced portfolio.
4. Before taxes and trading expenses. Includes reinvestment of dividends and interest.
5. Conducted by Charles Schwab Corp, published in November 2012.
6. Vanguard Research, Best Practices for Portfolio Rebalancing, July 2010.
7. The analysis assumes that some approximation of the stock and bond markets' historical return patterns, average returns, volatility, and low correlation can be expected to persist in the future. It also assumes that a portfolio holds a broadly diversified group of liquid assets with readily available market prices.