Even passive portfolios need an active hand when it comes to rebalancing and asset location. A mechanistic approach can undermine performance via taxes and fees. Instead, customize rebalancing to fit your clients’ unique goals and portfolios and you’ll be able to quantify the value you’ve added to the investment process.

“By constant self-discipline and self-control you can develop greatness of character.”

—Grenville Kleiser

Many investors erroneously assume, because passive investments are utilized to avoid subjecting them to the risk of materially underperforming their benchmarks, that investment management takes an easy, set-it-and-forget-it approach—other than occasional rebalancing back to targets. While that may be the case for some managers, managing passive portfolios well is actually far more personalized than what most passive or active managers do.

First, clients’ targeted asset allocation will change throughout their lives based on their unique goals, priorities, and the markets’ (mis?)behavior. Since the majority of the variance in investment returns can be explained by the allocation to stocks, bonds, and cash, advisors provide critical value to clients by selecting which portfolio allocation is appropriate for them based on their life priorities and funded status for their goals. But that is only the beginning of implementing and managing the portfolio.

Once the right allocation model for their financial plan is determined, it is critical that the client’s portfolio remain reasonably in balance relative to what you are targeting. Obviously, it would be possible to trade every day down to every dollar to rebalance to the target portfolio perfectly, but the tax consequence of doing so (i.e., short-term capital gains vs. long-term gains), the cost of transactions, and the bid/ask spread would easily destroy the tiny incremental value of maintaining that daily perfect balance.

However, if left unchecked and only revisited on a quarterly or annual basis, significant deviations in the performance of the account could occur. For example, if the account was 5% overweighted or underweighted in stocks and 5% underweighted or overweighted in government bonds for the entire year in the extreme markets of 2008, the portfolio total return could vary from what was targeted by +/- 2.8%. That may not seem like much in the context of the wild unpredictability of most active managers and the extreme markets of 2008, but when you are focused on minimizing the risk of material underperformance, it is too high a risk for clients.

Rebalancing methods

To combat this problem of keeping portfolios in reasonable balance, many active managers deploy one of two methods to rebalance portfolios, neither of which is very cost effective.
Some will just mindlessly rebalance the entire portfolio on some periodic basis such as monthly, quarterly, or annually. Unfortunately, doing this creates the same problem as daily rebalancing. There's a smaller cost because of less frequent trading, but there's still the additional uncertainty of being subjected to the risk of material underperformance if the markets are extremely volatile between preset calendar rebalancing periods. This approach is often referred to as "window dressing," because the trades being done might have no real value, but they make it appear that the manager is doing something.

Regardless of the method and reason behind such a rebalancing approach, it can generate needless short-term gains that could be avoided and introduces needless transaction costs and bid/ask spreads for what is sometimes an immaterial trade. Think about the example of the extreme markets of 2008 and how little the impact of overweighting and underweighting would be if instead of being 5% off of target you were only 0.5% off of target. The impact of this minor weighting difference would be +/-0.28% in your return instead of +/-2.8%. Is it worth nearly doubling your tax rate (with certainty comparing short-term to long-term gains) plus paying a 100% certain commission to lower the risk of 0.28% performance variance? We don't think so.

The other common approach, which is somewhat better but still introduces tax inefficiencies and needless transaction costs, is to monitor the weightings of all accounts on a daily basis and rebalance the entire portfolio only when the percentage weighting deviation is off target by some percentage or dollar amount. While this prevents the risk of extreme market movements from creating substantial deviations between calendar-based rebalancing periods, it nonetheless creates numerous small, needless trades that still introduce unnecessary costs, as well as short-term tax treatment that should be avoided.

Finally, merely for the sake of administrative simplicity, many managers will structure each individual account into the overall model that is being used. Every account, regardless of size or tax status, holds the same proportion of all of the securities. This limits the number of model portfolios the manager must maintain and is operationally much easier to automate, but it duplicates numerous unnecessary costs to the investor.

**Comparing rebalancing strategies**

Think about a simple example where a client has a personal IRA rollover of $700,000, a spousal IRA with $100,000, and a joint taxable account with $200,000 for a total investment portfolio value of $1,000,000. Also presume that the portfolio allocation model is simply constructed from just three positions: a total domestic equity market ETF, a foreign equity ETF, and a Treasury ETF.

To make each of the accounts match the model of, say, 52% domestic equity, 8% foreign, and 38% bonds (the remaining 2% is allocated to cash) takes a total of nine trades. Also assume that there is one point during the year when the weighting becomes off-target by a sufficient amount to justify rebalancing. This would normally trigger an additional nine transactions (a total of three buys and/or sells in each of three accounts).

This method creates a total of 18 trades for this client the first year just to keep the portfolio in balance in a simple three-position portfolio. That is nuts! With this approach comes higher commissions or at least bid/ask spreads in fee-based accounts (or justifies how excessive the fee-based commission is) and some potential unnecessary short-term taxable gains that can
nearly double the tax rate (short-term vs. long-term capital gains rates).

Now contrast it to our approach. Since the client is targeting 38% exposure of their $1 million in household assets to Treasury bonds, and the client has two tax-deferred accounts that make up 80% of their assets, we can keep all of the Treasury bonds in tax-deferred accounts to avoid the annual taxes on interest income. We would buy the Treasury ETF for 100% of the smaller $100,000 spousal IRA. We would then put 100% of the $200,000 taxable account in the domestic equity ETF for favorable long-term capital gain tax treatment. This saves us four trades right off the bat.

The remaining larger personal IRA account would act as a "completion fund" to bring their overall household allocation to target, requiring only three buy transactions. So, to initially position the household, we would do a total of five trades instead of nine.

Now, let's assume that the bond portion becomes overweighted and stocks underweighted during the year in an amount that is statistically significant, like 3%. The smaller IRA and taxable account would be left untouched, and the larger personal IRA would correct all of the variance in no more than two to three trades (depending on how underweighted domestic and foreign stocks are). This would result in no more than eight trades being done during the year including the initial positioning and a rebalancing event instead of what would normally be 18 trades the way most managers operate. Also, we would have avoided realizing any taxable gains.

If the situation was reversed and stocks became overweighted and bonds underweighted, the same rebalancing approach would be used, limiting the rebalancing to two to three trades instead of nine, again without any taxable gains being realized, short- or long-term.

Of course, if the largest account were instead a taxable account (say it was $500,000 in a taxable account with $300,000 in the personal IRA and $200,000 in the spousal IRA), we would need to implement the portfolios differently. For this example, we would structure the smaller IRA to be 100% in fixed income. In the larger IRA we may put the remaining $180,000 needed in fixed income, with $80,000 in the domestic equity and $40,000 in the foreign equity positions (for future tax-efficient rebalancing). In the $500,000 taxable account, we would have $440,000 in domestic equities (which brings the entire household to 52% domestic equity), $40,000 in foreign equity (bringing the household to the 8% target), and the remaining $20,000 in cash, to be allocated to the accounts where fees will be paid.

In this case, our initial positioning would be six trades instead of five as the first example showed, costing an extra $10 or so. But it still permits us to keep all of the fixed income in tax-deferred accounts and the majority of the equity in taxable accounts to capitalize on favorable long-term capital gains treatment. And it still offers us the ability to rebalance the entire household of portfolios with only two to three trades free of any realized tax treatment via the positions in the larger IRA. In the first year, with one rebalancing event, we would still be looking at a total of nine or fewer trades, with none of them triggering a tax event and with very efficient tax location management.

If stocks become underweighted, we could rebalance by making a purchase of more stock in the taxable account using any cash that might be available, or selling some bonds in the IRA to buy more stock. If stocks become overweighted relative to bonds, we could sell some of the equity position in the larger IRA and purchase more bonds there, improving tax location.
efficiency.

It is highly unlikely that any short-term taxable gains would need to be realized in the first year in the taxable account, because we have $120,000 in equities in the larger IRA that could be sold to correct for what would be a significant overweighting. Even if that unlikely extreme event occurred in the next couple of years, by that time the additional equities that would need to be sold in the taxable account would qualify for long-term capital gains treatment.

There is no hard and fast formula for how you do this. It is really just a matter of applying common sense based on the circumstances of the unique client. But clearly it is more tax- and cost-efficient for the client than just creating a blizzard of needless trades and related tax consequences that the standard rebalancing methods introduce.

**Contributions and withdrawals**

Of course, often portfolios have contributions, so any overweighting could be corrected by using contributions to the portfolio to buy just the underweighted security, correcting the overweighting through a couple of purchases over a period of several months, with each one reducing the extent of the tracking error being introduced.

The reverse is true for distributions, where we can usually fund monthly distributions from the accounts to meet client spending needs with six or fewer trades a year, each of them correcting some portion of overweighting and keeping the accounts tighter in tracking the allocation and avoiding holding excessive cash for extended periods of time.

Depending on the size of monthly deposits or withdrawals, instead of selling (or buying) all of the positions, we sell (or buy) the most overweighted (or underweighted) position every other month or so, resulting in perhaps six trades a year. This has the effect of continuously moving the account closer to its targets, delaying or preventing many other rebalancing triggers while also avoiding needless transactions.

Think about all of these benefits combined. The number of trades and bid/ask spreads is cut in half or more. Generally, the fixed-income securities are all (or at least a majority) in tax-deferred accounts, deferring current ordinary income taxation and much of the risk of tracking error introduced by municipal bonds, which for some clients would still be needed for taxable accounts.

Meanwhile, often all (or a majority) of the equities are owned in taxable accounts with favorable long-term gains treatment, avoiding future ordinary income taxation when distributed from tax deferred accounts and qualifying for a stepped-up basis at death. Introduce a Roth account into this equation and we have even more flexibility to avoid trading costs and taxation while minimizing tracking error.

In summary, taxes, bid/ask spreads, and transactions costs are a certain reduction of client after-tax wealth. With a disciplined approach of focusing on the things we can control in our portfolio implementation and ongoing management, we can limit the cost to our clients and add significant value far beyond what most money managers—active or otherwise—do. If you put the investor's interest first, there is a lot of additional value that you can add in managing a passive portfolio.
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