The Great Rebalancing Act:
Preserving the Risk-Return Relationship

Global diversification gives investors a valuable tool for managing risk and volatility in a portfolio. However, those who practice expert portfolio management know that along the way, portfolios require maintenance.

In a given period, asset classes experience divergent performance. This is inevitable and, in fact, desirable. A portfolio that holds assets that do not perform similarly (i.e., with low return correlation) will experience less overall volatility. That results in a smoother ride over time. However, dissimilar performance also changes the integrity of your asset mix, or allocation—a condition known as "asset drift." As some assets appreciate in value and others lose value, your portfolio's allocation changes, which affects its risk and return qualities. If an investor allows the allocation to drift far enough away from the original target, he or she ends up with a different portfolio altogether.

A portfolio engineered to match your current investment goals and risk tolerance requires that we preserve its structural integrity since asset allocation accounts for most of a portfolio's return. Maintaining the allocation is a strategic priority, not unlike portfolio design or investment manager selection. To efficiently pursue investment goals, we must manage asset drift.

Rebalancing is the remedy. To rebalance, we sell assets that have risen in value and buy more assets that have dropped in value. The purpose of rebalancing is to move a portfolio back to its original target allocation. This restores strategic structure in the portfolio and puts you back on track to pursue long-term goals.

Why rebalance?

At first glance, rebalancing seems counter-productive. Why sell a portion of outperforming asset groups and acquire a larger share of underperforming ones? Intuition might suggest that selling previous winners may hinder returns in the future. This logic is flawed; however, since past performance may not continue in the future.

Equally important, is that your original asset allocation is selected to accomplish your investment goals with a provision for your risk and return preferences. Rebalancing realigns your portfolio to these priorities by using structure, not recent performance, to drive investment decisions. Periodic rebalancing also encourages dispassionate decision making—an essential quality during times of market volatility. Moreover, if and when your overall financial goals or risk tolerance change, you have a foundation for making adjustments. In the absence of a plan, adjustments are a matter of guesswork.

Challenges and decision factors

In the real world, portfolio allocations are usually complex, incorporating not only fixed income and equity, but also the multiple asset groups within equity investing. The more complex a portfolio's allocation, the greater is the need for maintenance.

Determining when and how to effectively rebalance requires careful monitoring of performance and awareness of your tax status, cash flow, financial goals, and risk tolerance. Rebalancing also incurs transaction fees and potential capital gains in taxable accounts. So, while there are scientifically credible reasons to rebalance, we must always ensure that the benefits must outweigh the costs.

Given these challenges, our practical rebalancing approach establishes asset drift triggering points while leaving enough flexibility to manage costs effectively. Defining triggering points helps us decide *when* to rebalance. While rebalancing costs are quite low, we implement several strategies to minimize their impact:

- Rebalance with new cash. Rather than selling over-weighted assets that have appreciated, we seek to use new cash to buy more under-weighted assets. This reduces transaction costs and the tax consequences of selling assets.
- Whenever possible, we rebalance in the tax-deferred or tax-exempt accounts where capital gains are not realized.
- We incorporate tax management within taxable accounts, such as cost basis management, strategic loss harvesting, dividend management, gain/loss matching, and similar considerations.
- We implement an integrated portfolio strategy. Rather than maintaining rigid barriers between component asset classes and accounts, we manage the portfolio as a whole.

Rebalancing incurs real costs that can detract from returns. We define ranges within which investment components can acceptably drift, and adopt cost-saving strategies during rebalancing, paying particular attention to tax-sensitive transactions. In our rebalancing process, we implement a systematic and structured plan that remains flexible to each individual's unique blend of goals, risk tolerances, cash flow, and tax status.

No one can predict short-term movements in the capital markets—and that's certainly not a barrier to the achievement of your goals. In an uncertain world, we've ensured you have a well-defined, globally diversified strategy and we manage the portfolio to implement it over time. Rebalancing is a crucial tool in this effort.

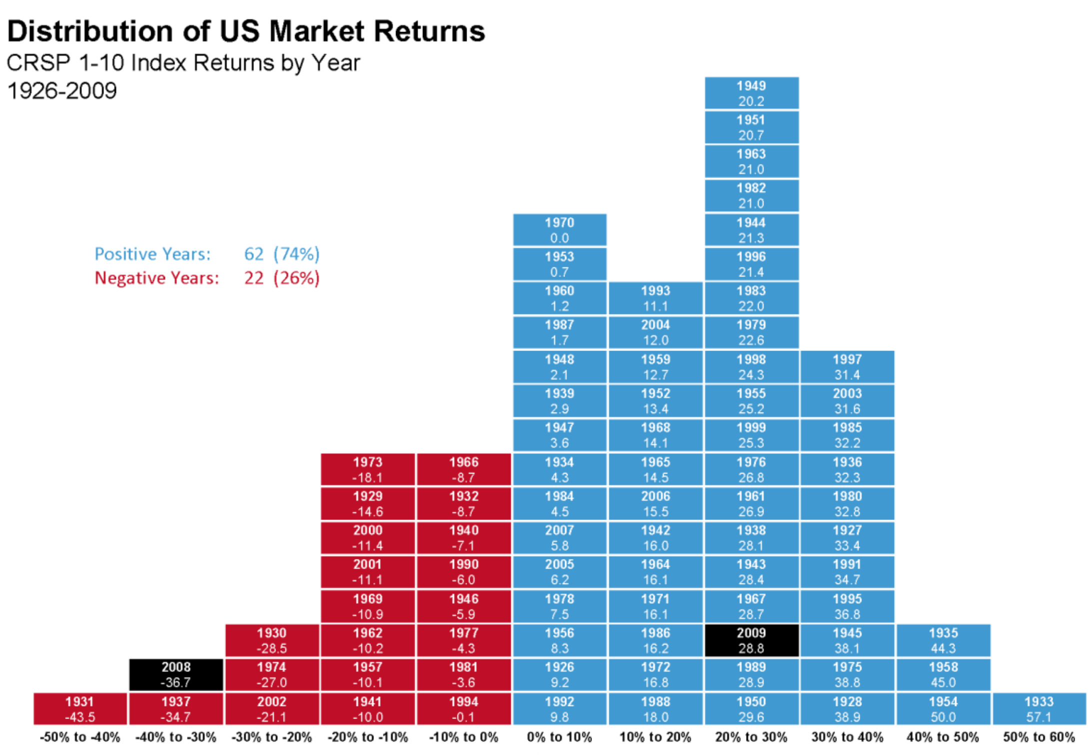
Recent Market Volatility in Perspective

The US stock market has taken investors on a bumpy ride in recent years. This volatility has tested investor discipline and prompted some people to question their commitment to equities. While no one knows the future, looking at the past may help you gain a better view of long-term market performance and put the recent market volatility in perspective.

The chart below shows the historical distribution of US market returns since 1926. The performance years are stacked in ascending order by return range. This chart illustrates that:

- Market performance over the past two years has been extreme by historical standards. In 2008, US stocks experienced their second-worst calendar return in eighty-four years. Then, in 2009, stocks rebounded strongly to deliver a return in the top quartile of the historical distribution.
- Over the long term, the market's positive return years have outnumbered the negative return years. Since 1926, the market has experienced a positive return in almost three-quarters of the calendar years.
- Not only are the positive years more numerous, the chart shows a larger concentration of performance in the higher ranges of returns.
- The sequence of calendar returns appears random, suggesting that accurately predicting future performance is a difficult task for any investor or professional manager.

Typically, the market has one down year for every three up years. Over time, the market has rewarded investors who can bear the volatility of stocks and stay committed through various periods of performance.



CRSP data provided by the Center for Research in Security Prices, University of Chicago. The CRSP 1-10 Index measures the performance of the total US stock market, which it defines as the aggregate capitalization of all securities listed on the NYSE, AMEX, and NASDAQ exchanges. Indices are not available for direct investment; therefore their performance does not reflect the expenses associated with the management of an actual portfolio. Past performance is not a guarantee of future results.

The Great Crash That Wasn't and the Propensity to Panic

As you know, here at Rockwood Wealth Management, we typically like to author our own client material. However, every once and awhile we find someone who simply seems to brilliantly express our thoughts in his or her words. The following words are Nick Murray's:

Beginning at about half past two in the afternoon of Thursday, May 6, and for roughly the following sixteen minutes, the Dow Jones Industrial Average fell very nearly 1,000 points. It was, in percentage terms, the fastest, deepest decline in stock prices in living memory.

Except that it never happened.

Financial professionals who experienced this cataclysm in real time—and others who just watched it on television—have assured me that it instantly became the sole focus of the entire country, that it was covered by the media as a confluence of 9/11, Pearl Harbor and the assassination of President Kennedy. (I missed it in its entirety, as I was during that very hour walking the encampment at Valley Forge, and fervently thanking God for the faith and endurance of Washington and his men. There may actually be a hint of sorts in this for the long-term investor: History trumps the news, every single time.)

In the hours after the market closed (having "risen" as quickly as it "fell," and recouped the preponderance of its "losses"), it became clear that this disaster had been, not to put too fine a point on it, some sort of a glitch. By the following day, the *New York Times* (America's newspaper of record) was gingerly ascribing potential responsibility to, and I quote, "algorithmic trading strategies," which is as elegant a way as I've ever seen of saying, "We have no earthly clue what the Sam Hill really happened, and no one else seems to, either."

Congress will, of course, hold hearings.

Just as you and I breathe oxygen, financial journalism breathes the ancient fallacy *post hoc ergo propter hoc*, which holds that simply because Event B happened subsequent to Event A, it was in fact directly caused by Event A. This is rarely true in the real world, and virtually never true in journalism's narrative of market causalities. Especially when—like the dog in the Sherlock Holmes story "Silver Blaze" which did nothing in the night-time—Event B (the market meltdown) never actually happened at all.

Thus one was treated, during and in the immediate aftermath of the crash that never was, to the journalistic narrative of Contagion: Greece As The First Domino. This narrative held not only that the crash was real, but that it was directly caused by an incipient global panic at the prospect of a systemic failure of the European Union, triggered by the inevitable implosion of as essentially trivial an economy as that of Greece.

As do many of its more ingenious catastrophist narratives, Greece as the First Domino gave (and continues to give) journalism cover against all such petty cavils as history and plain common sense. Why (some of us asked) are we getting all worked up about an economy roughly the size of Los Angeles County's, which has been in default of its sovereign debt during no fewer than 105 of the last 200 years? The answer, of course: Contagion. Greece, in this story line, would prove to be this year's Bear Stearns: just the opening act, the dead canary in the coal mine. But I digress.

The fundamental question regarding the events of May 6 is not, "What happened?" It isn't even, "Did anything really happen?" The question—between you, me and your financial advisor—is, *"How did you react to what appeared to be happening?"*

Did you really think that the values of the great companies in America and the world were suffering a serious and lasting diminution of their long-term value as businesses? (Did you, just to pick an especially grotesque example, think that Procter & Gamble, valued in the marketplace at over $60 a share at half past two, was really worth less than $40 a share sixteen minutes later?) Because if you did, you may once again have come face to face with a defining (yet still underappreciated) truth of real-life investing. To wit: ***for many of us, the single greatest obstacle to the pursuit of investment success is our own proclivity to panic.***

The corollary of this intensely liberating realization about ourselves is at least equally riveting: ***for many of us, the essence of long-term, real-life investment success will turn out to be the suppression of our own impulse to panic.*** Which leads directly to the conclusion that, if we doubt our own capacity single-handedly to overcome our deep susceptibility to panic, *the highest and best function of our financial advisor isn't to forecast the markets—something neither he nor anyone else can consistently do—but simply to talk us in off the ledge.*

The idea of a financial advisor as essentially a behavioral coach—improving his clients' investment returns by curbing their excesses of fear (and, at the other emotional extreme, of euphoria)—may strike you as novel. That's because, in the great scheme of things, it is. Indeed, only in 2002—when the behavioral psychologist Daniel Kahneman won the Nobel Prize in *Economics*—did the financial world begin to take serious notice that investor behavior, not investment performance, might be the greater determinant of real-life, long-term investment outcomes.

In the meantime, and as always, the first step in restoring your financial/emotional equilibrium is to reach out and turn off the television. In the ensuing peace and quiet, think of your investment strategy not in terms of some "market news flash"—reporting something which may or may not actually be happening—but in terms of your own life, and the lives of the people you love.

The news changes from moment to moment, and then evanesces, to be replaced by some other "crisis." (It will be All European Contagion All The Time until it's All China Slowdown All The Time, and if either of those "crises" shows signs of flagging, we can always go back to All Oil Spill All The Time.) The truth abides.

The truth is that a non-smoking couple of average retirement age (currently 62) has a joint life expectancy of 92. (That's highfalutin actuary-speak for the reality that the second person will pass, on average, thirty years hence.) Today's retiring baby boomer couples have, therefore, something like a thirty year investment time horizon, during which they must try to cause their money to outlive them, rather than the other way around.

Look at the crises that have come and gone just in the last thirty years. Look at the terrible bear markets in common stock prices which have reflected all those crises: six of them, including the greatest one-day wipeout in history (1987) and the two worst declines since the 1930s (2000–2002 and 2007–2009). Yet where are we now? Well, as I write, we've pulled back to about 10,000 on the Dow. On the same day in 1980, we were at 830.

What does that prove about the future? Why, nothing at all, of course. Nothing "proves" anything about the future, including—but not limited to—whether or not the sun is coming up tomorrow, and whether either you or I will be here to see it if it does.

But it sure is suggestive of something. What it strongly suggests to me is the probability that every living soul who panicked out of equities during those six bear markets—and in all the mini-crises, real and imagined, in between those six bear markets—wishes to heaven that he hadn't. **This is a club you probably don't want to join.**

At about the time you read this, I'll be in Normandy, walking yet another battlefield as it prepares for the 66th anniversary of the glorious and terrible struggle which took place there. I won't have a BlackBerry, or access to television, so the Dow may yet again appear to be going down 1,000 points—heck, this time it may even be going down 1,000 points—and yet again, I won't know it.

But if I did, I still wouldn't think it had anything to do with me. And, if you've got an investing time horizon even remotely approaching thirty years, I don't think it'll have much to do with you, either. ***Unless you panic.***

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