Long-term Perspectives

Portfolio management: Rebalancing discipline

Wealth Management
Dominion Securities

Portfolio rebalancing is fundamentally more about risk control than return enhancement. We look at how a consistent plan of action executed with discipline can help investors achieve their financial objectives.

Rebalancing keeps asset allocation on track

Asset allocation—the proportion of a portfolio invested in various asset classes such as stocks and bonds—is the primary determinant of long-term investment returns and risk. Tailored to an investor's financial objectives and risk tolerance, a well-structured asset allocation sets the foundational strategy for a portfolio and provides expectations for potential returns as well as the level of volatility an investor is likely to experience over the long term.

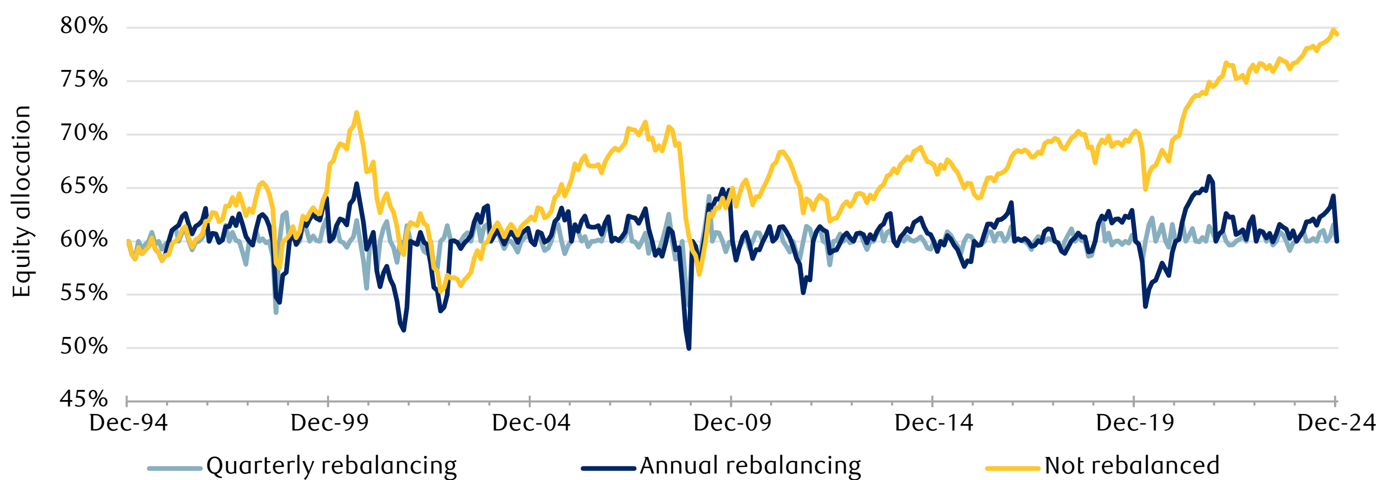
The discipline of rebalancing offers investors a useful portfolio management tool to maintain their strategic asset allocation over time, keeping portfolios aligned with their intended asset mix and expected risk-return characteristics. Without periodic rebalancing, market movements can gradually shift a portfolio away from its strategic asset mix, as different assets appreciate at different rates over time. This "drift" from target allocations can potentially expose investors to unintended levels of risk and volatility that they may not be prepared or need to endure (see exhibit).

A tool for risk management, not return enhancement

We believe the primary function of rebalancing is to keep a portfolio's expected level of risk aligned with the defined risk tolerance for an investor. Absent rebalancing, portfolios naturally drift towards assets that have

Absent rebalancing, market movements can shift a portfolio far from its targeted strategic asset mix

Equity allocation drift of a 60/40 balanced portfolio with and without rebalancing



Based on a hypothetical portfolio consisting of 60% Canadian equity assets (represented by the S&P/TSX Composite Total Return Index) and 40% Canadian fixed income assets (represented by the FTSE Canada Universe Bond Index), excluding transaction costs.

Source - RBC Wealth Management, FactSet; monthly data through 12/31/24

All values in Canadian dollars and priced as of December 31, 2024, market close, unless otherwise noted.
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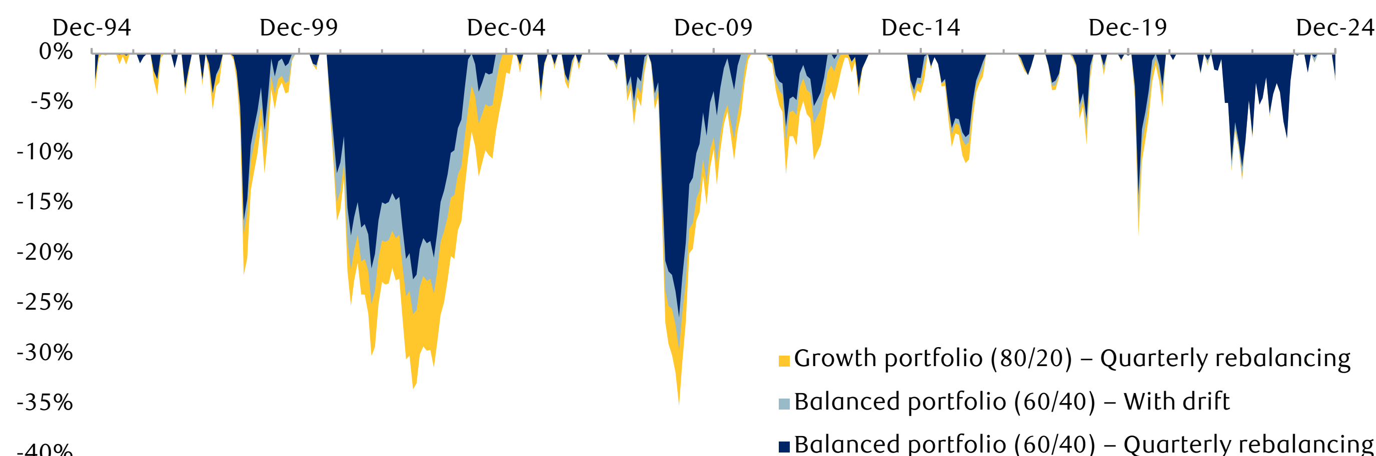
Absent rebalancing, periods of extended drawdown are worse and take longer to recover from

Drawdown experience: Rebalanced versus not rebalanced



Based on hypothetical portfolios consisting of 80%/60% Canadian equity assets (represented by the S&P/TSX Composite Total Return Index) and 20%/40% Canadian fixed income assets (represented by the FTSE Canada Universe Bond Index), excluding transaction costs.

Source - RBC Wealth Management, FactSet; monthly data through 12/31/24

delivered higher returns, which tend to be more volatile and riskier than other parts of the portfolio. In positively trending markets, this drift effect towards higher-returning assets can seem beneficial—boosting returns beyond those of the intended strategic allocation. But when market volatility arises, the downside can be considerably steeper than an investor anticipated. While it may be sensible to allow portfolios to benefit from some upward market momentum at times, the imbalanced exposure to assets that typically carry more risk can leave investors vulnerable to meaningfully larger losses than they were prepared for (see exhibit above).

Without periodic rebalancing, portfolios can be prone to worse drawdowns and more protracted recoveries, on average. Meanwhile, past instances of extended market corrections, such as the global financial crisis and the dot-com bubble, have shown that portfolios allowed to drift significantly from their target allocations often take far longer to recover (see first table below).

Portfolios that lack a rebalancing discipline also tend to exhibit higher levels of volatility over time, without necessarily a commensurate increase in returns. This imbalance between volatility and returns can lead to diminished risk-adjusted outcomes (see second table below).

Rebalanced versus not rebalanced

Drawdown analysis: Absent rebalancing, portfolios tend to experience worse drawdowns, on average

	Average drawdown	Maximum drawdown		Longest drawdown	
		Magnitude	Recovery period	Magnitude	Recovery period
Balanced portfolio (60/40) – Quarterly rebalancing	-4.2%	-26.3%	18 months	-22.5%	17 months
Balanced portfolio (60/40) – Annual rebalancing	-4.3%	-26.2%	18 months	-23.7%	17 months
Balanced portfolio (60/40) – With drift	-4.9%	-29.6%	20 months	-26.0%	26 months

Long-term risk-return characteristics: Fundamentally, rebalancing is more about managing risk than enhancing returns

	Annualized return	Annualized standard deviation	Sharpe ratio
Balanced portfolio (60/40) – Quarterly rebalancing	7.8%	9.1%	0.58
Balanced portfolio (60/40) – Annual rebalancing	7.7%	9.2%	0.56
Balanced portfolio (60/40) – With drift	7.8%	9.9%	0.53

Based on a hypothetical portfolio consisting of 60% Canadian equity assets (represented by the S&P/TSX Composite Total Return Index) and 40% Canadian fixed income assets (represented by the FTSE Canada Universe Bond Index), excluding transaction costs.

Source - RBC Wealth Management, FactSet; data range 12/30/94–12/31/24

Establishing a rebalancing framework

From a top-level perspective, there are two primary rebalancing approaches:

- **Time-based rebalancing:** The simplest approach involves rebalancing at fixed intervals—quarterly, semiannually, or annually—which, if preferred, can be aligned with the schedule of portfolio reviews. While straightforward to implement, this method can be somewhat arbitrary as it does not account for market conditions or the extent of portfolio drift.
- **Threshold-based rebalancing:** A more dynamic approach involves setting thresholds or "tolerance bands"—predetermined percentage thresholds around target allocations. For example, if the target allocation to an asset class is 50% of the portfolio, then "trigger points" may be set at 45% and 55%, prompting action only when the allocation drifts beyond this ±5% rebalancing corridor for that particular asset class.

The mechanics of rebalancing involve several tradeoffs that merit consideration:

- How often should the portfolio be rebalanced?
- What levels of deviation from target allocations should be tolerated?
- Should rebalancing restore allocations fully to their targets or within an acceptable range?

Additional considerations when formalizing a rebalancing approach include: monitoring frequency, transaction costs, asset class characteristics and liquidity, tax implications, and risk tolerance.

For instance, higher transaction costs, lower risk aversion, and taxable investment accounts would tend to favour a less frequent rebalancing strategy or one with a wider "tolerance band," as these guidelines are relatively more optimal in minimizing costs and tax burdens.

One of the more nuanced considerations in rebalancing is the tax implications of transactions. In tax-advantaged accounts, rebalancing is often more straightforward. In taxable accounts, however, rebalancing can trigger capital gains since it typically involves selling assets that have appreciated in value. This underscores the importance of tax-aware implementation, such as using new capital contributions, income distributions, or withdrawals to rebalance opportunistically or harvesting unrealized capital losses to offset gains.

The role of consistency and discipline

No one-size-fits-all approach exists when it comes to portfolio rebalancing. Time-based rebalancing offers simplicity, while threshold-based rebalancing provides more precise risk control, albeit with added complexity. The "optimal" strategy depends on understanding the tradeoffs between a host of factors specific to each investor.

What matters most when it comes to rebalancing, in our view, is consistency and discipline. It is crucial to recognize that the primary purpose of rebalancing is not necessarily to enhance returns, but to ensure that a portfolio stays aligned with the risk-return balance embedded in a selected strategic asset allocation profile.

Over the long term, rebalancing, executed with discipline, can benefit investors by maintaining the desired volatility and return characteristics in their portfolios by creating a consistent plan of action to help achieve their financial objectives within the defined risk profile. We recommend that portfolios should be evaluated for rebalancing at least once a year, and more frequent evaluations would be appropriate during more volatile markets as asset allocations may deviate quickly from target ranges (see exhibit).

Multi-horizon portfolio risk and return: Rebalanced versus not rebalanced

Rebalancing, executed with discipline, helps investors maintain the intended risk-return characteristics in their portfolios

	Annualized return			Annualized standard deviation			Sharpe ratio		
	10 years	20 years	30 years	10 years	20 years	30 years	10 years	20 years	30 years
Balanced portfolio (60/40) – Quarterly rebalancing	6.1%	6.6%	7.8%	8.8%	8.5%	9.1%	0.50	0.57	0.58
Balanced portfolio (60/40) – Annual rebalancing	6.1%	6.6%	7.7%	8.8%	8.5%	9.2%	0.51	0.57	0.56
Balanced portfolio (60/40) – With drift	6.8%	6.8%	7.8%	9.9%	9.5%	9.9%	0.53	0.54	0.53

Based on a hypothetical portfolio consisting of 60% Canadian equity assets (represented by the S&P/TSX Composite Total Return Index) and 40% Canadian fixed income assets (represented by the FTSE Canada Universe Bond Index), excluding transaction costs.

Source - RBC Wealth Management, FactSet; data range 12/30/94–12/31/24

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