

Investment Strategy

To rebalance or not to rebalance?

This paper was written by Watson Wyatt's Global Investment Committee, a group of nine leading consultants responsible for formulating and communicating global views on investment opportunities, news and events.

Following the very negative returns from almost all risky assets in 2008, many pension funds that adopted a fixed weight strategic asset allocation policy will now find themselves substantially underweight to riskier assets compared to more secure assets.

Our core advice at this time is not to rebalance without a review of the suitability of the existing strategic asset allocation policy. In this note we set out the key reasons behind this advice, and some commentary on circumstances where it may be less relevant.

In particular, we think that the economic, capital market and political environment is now very different from that which pertained when many funds set their current strategic benchmarks.

Rationale for our advice

Rebalancing, at its heart, is a process for keeping asset exposure close to an agreed target benchmark, and is beneficial because it limits the risk of returns diverging substantially from the benchmark. This is a real risk for those who are open to criticism from third parties who do not fully understand the investment policy being adopted. In practice, significant divergence from an agreed strategic position can lead to a substantial draw on the time of trustees to explain the divergence and, if left unchecked, can cause problems between stakeholders, where one party considers the other not to have "done its job." Frictions of this type are significant problems where trustees have limited time available to devote to investment issues.

Rebalancing does not, however, reduce risk in an absolute sense or relative to a liability-related benchmark – at least it does not reduce "extreme event" risk. This can be most simply understood by recognizing that, as risky assets fall in value, rebalancing involves buying more risky assets, thereby increasing losses if assets continue to fall.

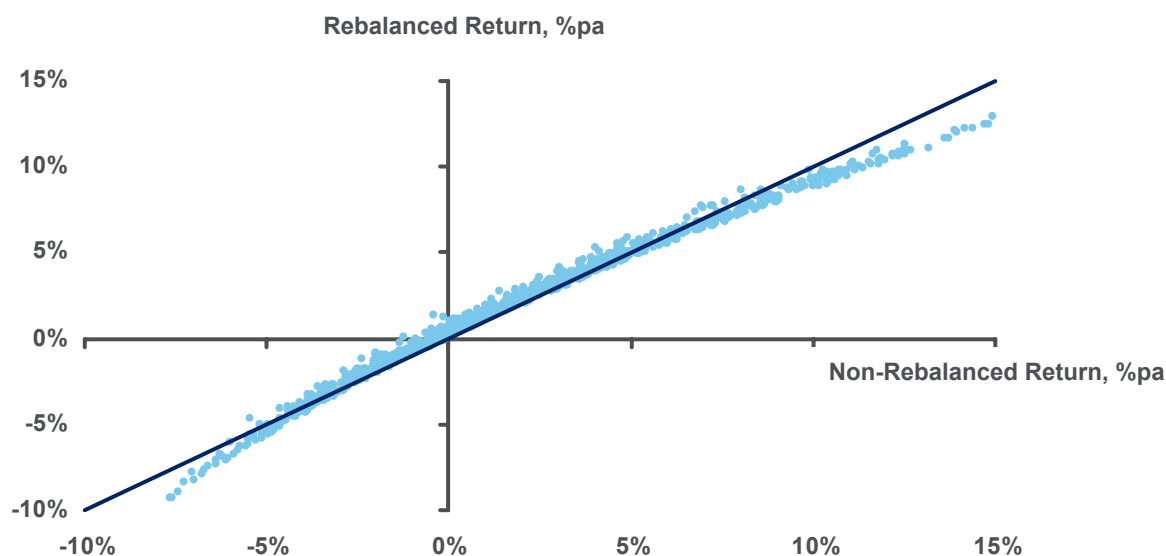
Rebalancing changes the distribution of future portfolio return outcomes. To see the potential impact of rebalancing in different scenarios, we can consider the future outcome for risky assets in three distinct capital market regimes:

- **Risky assets by and large fall over time.** Examples of this regime are U.S. equity returns in the Great Depression, the “stagflation” 1970’s, as well as Japanese equities in the 1990’s. This is the worst outcome for risky assets in aggregate over longer periods;
- **Risky assets by and large rise over time.** Examples here include the great U.S. equity bull market from 1982-2000, the Swedish stock market in the first decade of the 20th century, and Japanese equities from 1950 through 1989. This is the best outcome for risky assets in aggregate over longer periods; and
- **Risky assets move up and down within a broad range.** This is the most likely outcome over long periods of time and across markets and results in the returns from risky assets running from modestly bad, through “expected” to modestly good.

Rebalancing reduces returns in the first two regimes and adds to returns in the third. This is not a debate about whether risky assets trend or mean revert, but rather an observation that rebalancing changes the distribution of future outcomes. In fact, rebalancing is akin to writing put options – it increases returns as long as returns are neither very bad nor very good, as the premium is received, but worsens returns in the tails, when a greater return cost is incurred (e.g., an equity seller sees equities continue to rise after they’ve lightened their portfolio’s actual equity weight).

We have simulated the impact of annual rebalancing versus not rebalancing for a portfolio with 50% cash (with assumed zero risk and return) and 50% equities (3% pa mean, 20% volatility, and log-normal distribution) over five years (**Figure 1**). The curved pay-off reflects the option-like nature of the rebalancing activity, although the return from rebalancing is small relative to the overall returns achieved.

Figure 1 | An "option-like" pay-off from rebalancing



Source: Watson Wyatt

In “normal” circumstances we consider the benefits of managing risk versus benchmark to outweigh the small change in the distribution of returns. However, there are two sets of circumstances where we think this might not be appropriate:

- Where there is doubt as to whether the strategic benchmark is actually appropriate; and
- Where the size of the deficit is or is becoming large compared to the sponsor’s ability or willingness to cover the deficit (for defined benefit (DB) funds) or large relative to the investor’s ability to absorb losses (DC fund).

At present, we believe that there is significant doubt regarding the first point for most funds, and there may well be a concern regarding the second point for many funds as well.

Is your strategic benchmark still appropriate?

Most pension funds set their strategic benchmark as a series of specific allocations to asset classes, e.g. 40% equities, 10% alternatives etc. In reality, the analysis and decision-making processes that came up with these allocations is not precise. Indeed, in many cases, allocations as much as 5%-10% different from the eventual benchmark could probably have been justified. This suggests that not rebalancing within a reasonable range could be justified as being consistent with the strategic goals, albeit diverging from the specific allocations set.

While changing the choice of strategic benchmark is not a decision to be made lightly, we think the economic, capital market and political environment is now very different to that which pertained when many funds set their current strategic benchmarks. While a review of strategy now might reconfirm the current strategic benchmark – in which case rebalancing would be appropriate – there is a significant chance that such a review would conclude that some changes were necessary, in which case any rebalancing now might be to an unsuitable strategic benchmark.

Our main concern is a rebalancing into riskier assets now, when a review of strategy then sets a new benchmark with a lower allocation to risky assets. There are a number of factors that suggest that a lower allocation to risky assets in the strategic benchmark might be appropriate going forward, particularly for funds that have frozen or minimal future benefit accruals:

- A significantly elevated level of uncertainty in the economy and capital markets. This makes judgments about taking risk harder and therefore creates some preference for avoiding risk;
- A significantly higher level of mark to market volatility. This makes risk per unit of capital invested higher; and
- Potentially higher expected returns per unit of capital invested. This means lower allocations to risky assets are needed to achieve a given return level.

Offsetting these are reasons why the same or higher allocations to risky assets might be considered appropriate:

- A view that risky assets are “cheap” and offer higher returns for the risk they carry than when the last review was undertaken; and
- Increased deficits might require higher returns to be achieved going forward.
- We find the “cheap” argument difficult to agree with currently, given the macro headwinds created by the systemic deleveraging process.

Are markets depressed due to risk aversion or the banking crisis?

Many investors are debating whether markets are depressed compared to some concept of fundamental value. However, this is not really a question of rebalancing policy, but rather one of taking a market view. Consequently, we address this in our macro and asset class notes.

Should the level of risky assets have regard to the solvency level of the fund?

The issues related to the impact of increased deficits will be debated widely by many trustee boards and their sponsors. We note, however, that if trustees have taken risk on the basis that their sponsor can cover any losses and then, when losses do occur, the response is delay contributions as long as permissible under ERISA and to take more investment risk, then the original premise for risk taking is brought into doubt. We find the argument for increased risk taking as deficits increase (“save less and swing harder”) to be unconvincing other than when the deficits are small compared to the sponsor’s balance sheet.

An area that we suggest needs greater consideration in the current environment of weakened sponsor financial circumstances is whether there is a maximum deficit that can be allowed to emerge before risk is reduced. The same issues can be considered for DC investors who arguably have a weaker ability to withstand losses given reductions in job security and loss of wealth elsewhere in their personal assets.

For a DB fund, the largest deficit that many trustees would wish to see would be related to the maximum amount of cash that could realistically be drawn from the sponsor, in light of today’s business and credit market environment (many sponsors fund pension contributions by borrowing in the capital markets, which has become progressively more expensive in recent months).

In broad terms, we believe that risk levels should be reduced as the deficit gets larger, with substantial risk reduction as the deficit approaches the maximum amount of cash or assets that the sponsor can provide over time. We note the asymmetric payoffs to U.S. plan sponsors for large changes in funded status, where the 80% and 60% funded status levels trigger undesirable reporting (participant notices) or corporate action (PBGC put) events.

Should some funds rebalance?

Our view is that funds should review their strategic policy before rebalancing. In addition, we see a number of reasons why some funds might prefer to have lower allocations to risky assets in the short term than their strategic policy suggests.

However, all investors need to weigh their beliefs about long-term investment against their ability to adapt their thinking as circumstances change. This might well lead some funds to conclude that, while a review of strategy is appropriate, they should rebalance in part now and leave further rebalancing until the review is complete.

Indeed, some funds already have ranges within which they do not rebalance. For those funds where the ranges are relatively tight, and are intended mainly to prevent spurious

transactions, then the debate should be more about rebalancing in full, rebalancing in part or not rebalancing. For those with wide ranges, where part of the rationale for them was a recognition that setting policy as a specific allocation to each asset class is inappropriately precise, then rebalancing risky assets back to the bottom of these ranges may be appropriate.

Finally, we would note that our main concern about rebalancing relates to movements from highly secure assets into risky assets – a point of particular relevance where the fund is frozen and/or when liability-matching assets play a prominent role in fund's the strategic benchmark. We believe that rebalancing between strategies that have similar risk levels is appropriate to avoid concentration risks but, of course, regard must be given to the elevated levels of volatility and transaction costs that are prevalent in most markets at present.

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