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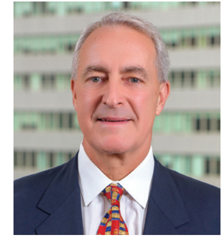

Thoughts for Investors

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The Myths and Dangers of Portfolio Rebalancing

Winter 2024

"Nothing is more deceptive than an obvious fact."

– Sherlock Holmes

The goal of creating financial wealth is to meet financial obligations, known and yet to come. One industry process commonly considered for preserving financial wealth is rebalancing. The idea of rebalancing a portfolio over time is widely considered as a strategy that can help mitigate concentration risk and deviations from target allocations. Changing the allocation between asset classes or investments by selling some/all of one and buying another, investors are advised, may reduce the traditional concept of "risk."

However, I believe that advice from some great investors may suggest otherwise. We believe rebalancing may inadvertently increase the risk of not achieving goals because it often becomes emotionally driven instead of investment driven and automatic when it should be thoughtful. Let me explain.

"Sell a stock only when you have found a new stock that is a 50% better bargain than the one that you hold."

– Sir John Templeton, famous value investor

The first potential risk of rebalancing is selling good investments too early. Templeton's advice creates a high hurdle for both selling and buying. Rebalancing can put financial goals at risk if replacement investments can't/don't "pick up the slack" or turn out to be inferior. *Selling too early is perhaps the greatest investing mistake I've seen in my 40-year portfolio management career.* We often hear, "It never hurts to take a profit." In our experience, that is most often uttered by investors who sold too early.

"The idea of measuring investment risk by price fluctuations is repugnant to me, for the very reason that it confuses what the stock market says with what actually happens to the owners' stake in the business."

– Benjamin Graham, famous value investor

Why do investors sell too early? If a stock goes from $10 to $20, they are happy and look forward to more gains. But if it goes from $10 to $30 and back to $20, they assume "something is wrong" and should have sold. So, they rebalance, selling some stock, regardless of fundamentals. As Graham advises, don't confuse "price fluctuations" with risk and sell too early because you are trying to reduce risk. Paying taxes along the way also erodes your capital. While past is not prologue, my experience is that portfolios I've seen with the greatest gains often belong to those who *almost* never sell great investments.

"The first rule of compounding is never interrupt it unnecessarily."

– Charlie Munger

So, when is selling appropriate? Sell for four reasons: you need the money, you made a mistake in your analysis, the fundamental reasons for owning are deteriorating (different from *price volatility/fluctuation*), or you found a better opportunity. Otherwise, don't "interrupt compounding", in a mechanical fashion, such as with rebalancing or "target date" funds.

"If the job has been correctly done when a common stock is purchased, the time to sell is almost never."

– Philip Fisher, famous growth investor

The second potential risk of rebalancing is selling because you fear owning "too much" of a superior investment, not because you fear it's inferior. This may cause you to inadvertently "rebalance" into what turns out to be an inferior investment. In the past we've been asked about cannabis, blockchain, China, autonomous driving, etc., in the name of "diversification" and "rebalancing." How have these worked? On the other hand, if you own both Apple and Microsoft, you may be advised to reduce them, or to ignore additional "technology" investments because you own "too much." How much overlap do these two companies have? Likely the same as a plane and a car, both "transportation."

"People calculate too much and think too little."

– Charlie Munger

Wealth cannot be preserved until it is first created. As they say in sports, "the best defense is a good offense." The third potential risk of rebalancing is when defense or "selling", takes priority over offense or "buying." That's backwards. First and foremost, concentrate on finding and buying great investments in asset classes with at least a history of returns. Jim Reid, Head of Thematic Research for Deutsche Bank conducted a Long-Term Asset Return Study 2022. He explained that "In the US, over the last 100 years…", the "real" (inflation-adjusted) annual returns of various asset classes were as follows: gold 0.4%, oil 0.5%, housing (not including rents) 1.1%, 10yr and 30yr government bonds 2.02%, and equities 7.22%. Specific investments in any asset class may vary, the future will certainly change, and investors will forever be inundated with new stories of impending doom and gloom. Historically, concentrating on defense by reallocating out of stocks and into any other asset class has, in the long run, proven to be much less rewarding and at times just as volatile and "risky."

"To establish the right price for a stock the market must have adequate information, but it by no means follows that if the market has this information, it will thereupon establish the right price."

– Benjamin Graham

Then is the task of reducing risk and protecting wealth hopeless? No, though don't expect having "adequate information" assures the market will "establish the right price" and enable you to quantify the risk. That's often due to the outsized impact of "emotion" on prices. So much for the theory that stock prices, and the stock market are "rational" and "efficient."

If investors desire to reduce risk, they must first quantify risk's effect on financial goals. A good financial plan can help aid in distinguishing emotional risk from investment risk (speak with Selene Zhao, our team's Certified Financial Planner™ professional for help with this.) It's important to remember, *risk is an opinion not a calculation*, making assessing risk difficult and imprecise. The tendency is to use "price fluctuations" or "volatility," as proxy for risk. *Volatility is not risk unless you don't know the difference*. Like the risk of a roller coaster, everyone perceives investment risk differently because of emotion.

"The big money is made not in the buying or the selling, but in the waiting."

– Charlie Munger

In summary, review your portfolio for quality and its ability to "create" wealth. *That must come before you can worry about "preserving" it*. Guard against selling too early. Don't fear owning a lot of a superior investment. Rather fear "rebalancing" into inferior investments by mistake. If your portfolio is moving toward your financial goals, any rebalancing should be done cautiously and infrequently. Otherwise, it can easily become emotionally driven vs. financially driven.

"I am in a small minority on the idea of rebalancing. I don't think you need to do it. The data bear me out, because the higher-yielding asset is going to be stocks over the long term. That's the way the capital markets work. Not in every 10-year period, or even for that matter every 25-year period. But the higher-returning asset you're getting rid of to go into a lower-returning asset, so it dampens your returns, and the differences turn out to be, if you look at 25-year periods, very, very small. Sometimes rebalancing improves your returns. Sometimes it makes them worse." "Yes. There is a comfort level for an investor and a feeling of he's kind of protected as much as you can be protected in these volatile days. So, it's a behavioral problem." "And you try and not do it with any great frequency."

– Jack Bogle, Vanguard founder in an interview with Morningstar on rebalancing

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