Print Format Sponsored By

The Last Frontier

JULY 3, 2013 • JAMES PICERNO

If you could choose just one piece of strategic information for managing portfolios, what would it be? Market forecasts? Economic projections? Surveys of investor sentiment? The possibilities are endless in the information age.

But you certainly can't make informed investment decisions without knowing the fluctuations of your asset allocation. Everything else pales by comparison. If a portfolio is heavily overweight in, say, U.S. stocks, the outlook for equities isn't all that relevant because it's probably time to pare back the allocation anyway, no matter what the future may bring. The fact that the allocation has shifted tells you a lot, perhaps all that you need to know.

In other words, rebalancing is a critical aspect of money management—more important even than the initial asset allocation choices (assuming you don't go to extremes with the portfolio design). That's because details matter. A lot.

There's no room here for rules of thumb and casual oversight—the standard practice in years past, when exploiting the raw data in client portfolios was difficult and expensive.

"Rebalancing software was once a luxury that only large RIAs with around $1 million in revenue could afford," says Bill Winterberg, a financial technology consultant.

Thanks to increasingly powerful computers, falling technology prices, and an expanding menu of software products, it's easier and less costly to make rebalancing decisions. Yet only 10% to 15% of advisors use "intelligent rebalancing software," estimates Joel Bruckenstein, the publisher of Technology Tools for Today (and a Financial Advisor columnist).

The market penetration remains relatively low, largely because of the cost in time and money, he says. "These software apps aren't easy to use, but they've gotten better over the years," says Bruckenstein.

They're also becoming less expensive, and in some cases free. TD Ameritrade earlier this year announced that its iRebal software, which can cost advisors as much as $50,000 a year in licensing fees, would be available at no charge in a Web-based version for its advisor clients.

Still, some wealth managers steer clear of these products in a mistaken belief that there's little if any value to automating the rebalancing process. Others fear these products are a slippery slope toward speculative trading, or that leading-edge rebalancing analysis leaves asset allocation decisions at the mercy of a black-box strategy.

But advisors who sidestep these programs will be managing portfolios as if it were 1985—with a spreadsheet. If that's what passes for state-of-the-art, the returns may be lower and the risk may be higher. Their competitive advantage with clients will be thinner, since rivals down the street will likely have given up trying to outrun computers.

But let's be clear: The goal isn't to rebalance more often or more aggressively. The objective is to rebalance more intelligently. That means using software to identify the right time to rebalance with the optimal combination of trades, based on parameters defined by you and your clients. As you move closer to this ideal, you boost the odds that you'll find those sweet spots in real time and execute the trades quickly and efficiently. But you'll have to look frequently and comprehensively across all the accounts under your charge. And that means using rebalancing software to do the computational heavy lifting.

The Software Solution

Once upon a time it was virtually impossible to monitor the shifting landscape of a portfolio structure in detail, across all accounts, every day or every week. That's probably why simple rebalancing guidelines—once a quarter, for instance—became popular. But even if you run the numbers infrequently in spreadsheets, when you do fire up Excel it's still a tedious, time-consuming job that's prone to error and sub-optimal decisions.

Technology circa 2013 offers a better way, for reasons that go beyond easing your workload. "You're also going to provide better service for clients," says Craig Iskowitz of the Ezra Group, a financial technology consultancy. Rebalancing software, he explains, makes it easier to build and manage custom investment strategies, such as a socially responsible portfolio that closely matches an investor's preferences.

For advisors to fully appreciate what these products offer, it's helpful for them to think about the hurdles and opportunity costs of managing asset allocation the old way. Using spreadsheets to explore the possibilities is a time sink, which takes you and your associates away from more important tasks, such as talking to existing clients, searching for new business and attending to any number of other projects that can't be farmed out to software. Just ask John Lunt, president of Lunt Capital Management, who says that RedBlack Software's Rebalance Express "lets us spend our time adding value instead of dedicating people and resources to areas where we can't add value."

Iskowitz says he consulted with an advisory firm that was still using spreadsheets to manage more than 1,300 accounts. "It takes days to rebalance," he notes, which is one reason he is helping the shop transition into rebalancing software.

Embracing technology doesn't mean using a black-box solution. You still make the final decision about how and when to adjust the asset mix—choices that are available through customization features in most software products. But it's the technology's job to sort through portfolios and identify where attention is required—and where it's not.

J.D. Bruce, the president of Abacus Wealth Partners, says that before his firm started using iRebal software, the allocations in some of the more complicated accounts could be left to drift for as long as six months. When the time for action arrived, it could take several hours to sift through the portfolios and manually handle the trades, he says. "And the advisors did the work. When you use iRebal, it does the same thing, but it does it in two minutes—all 800 clients at once."

FIGURE 1

Rebalancing Software Makers

SOFTWARE	COMPANY	WEB SITE
iRebal	TD America	iRebal.com
Total Rebalance Expert (TRX)	Total Rebalance Expert	www.trxpert.com
Rebalance Express	RedBlack Software	redblacksoftware.com
Advisor Rebalancing	Envestnet I Tamarac	tamaracinc.com
TradeWarrior	TradeWarrior Software	tradewarriorsoftware.com

The potential of rebalancing is underestimated. Many think frequent portfolio reviews are pointless. But that widely held assumption crumbles once you consider the multiple factors at play, including the market volatility, the taxes and the ongoing liquidity flows triggered by clients. The full spectrum of opportunities is even more complex if clients have assets located in multiple accounts—so-called asset location decisions.

“There are two sides to rebalancing and portfolio management: deciding what needs action and actually doing it,” says Sheryl Rowling of Rowling and Associates, who co-created the Total Rebalance Expert (TRX) software. In order to take action, it’s essential to have good intelligence. That’s no mean feat, given all the possibilities within all the portfolios you’re likely overseeing.

A fair amount of rebalancing analysis means looking for trades with the greatest potential for adding value. No less valuable is the software’s ability to steer you away from those accounts that don’t add value. There’s only one way to reach this state of information nirvana: crunch the numbers on all the portfolios and estimate whether the potential payoff for a set of rebalancing trades will exceed the costs or risks. This requires software specifically designed for this task.

The Rebalancing Matrix

It also means looking deeper and more frequently at trades. Market volatility is an obvious signal, which is why it receives most of the attention in the research literature. Numerous studies over the years show that rebalancing, under the right circumstances, can deliver what financial advisor and author William Bernstein labels the “rebalancing bonus.” Although analysts debate the precise definition of “ideal” circumstances, they often point to a set of assets exhibiting high volatility and low correlation to each other. Bernstein demonstrated this point mathematically, concluding that “the intrinsic rebalancing potential of any asset pair is the difference between its mean variance and covariance,” (a quote from his study, “The Rebalancing Bonus: Theory and Practice,” at Efficientfrontier.com).

In fact, there’s another factor to consider: mean reversion. “Without that, you don’t have anything,” says Andrea Nardon, a fund manager who oversees quantitative research at Bank Sarasin in London. In a recent working paper (“Portfolio Rebalancing: A Stable Source of Alpha?”) Nardon and his co-author found that “the presence of high volatility and low correlation helps in generating a positive rebalancing bonus, but they act mainly as amplifiers. The essential condition is the presence of relative mean reversion.”

Diversifying a portfolio across asset classes can boost the odds that this “essential condition” is present, but the future is always uncertain, and so it’s never clear if mean reversion will prevail. If it were the only incentive to rebalance, it would likely suffice for an investor to make infrequent, ad hoc calendar adjustments to a portfolio with spreadsheets. But there's more to rebalancing than responding to Mr. Market's volatility tantrums.

For accounts that must pay Uncle Sam his cut, the spread between before- and after-tax returns can be surprisingly wide, especially for wealthy clients in upper-income brackets. In those cases, rebalancing and related adjustments can be powerful tools for minimizing the tax bite. Taxes offer a jigsaw puzzle that demands regular attention—and decisions on maximizing tax-loss harvesting, choosing specific lots of securities to sell and factoring in asset location. Consider one of the seminal papers in tax and investment literature: "Is Your Alpha Big Enough To Cover Its Taxes? The Active Management Dichotomy," by Robert H. Jeffrey and Robert D. Arnott, writing in the spring 1993 issue of The Journal of Portfolio Management. The study found that the short list of actively managed funds beating the S&P 500 was cut roughly in half after investors adjusted their returns for capital gains and dividends taxes.

That study still resonates 20 years after its publication. The message (supported by subsequent studies) is twofold. One, you can't afford to ignore taxes for taxable accounts. Two, after-tax alpha can be substantial. A recent study from Parametric Portfolio Associates ("Simulating Loss Harvesting Opportunities Under Different Tax Environments") estimated that after-tax alpha can range from roughly 100 to 200 basis points a year with a carefully designed tax management strategy. What's more, after-tax alpha tends to be relatively reliable—unlike the returns of the pretax, beat-the-benchmark variety.

Clients seem to recognize the stakes. Three-quarters of advisors say their clients "expect" tax-aware strategies, according to a recent survey of CFA Institute members (called "Tax-Aware Investment Management Practice," which appears in the fall 2009 issue of the Journal of Wealth Management).

Furthermore, portfolio rebalancing is complex simply because the client is. Investment accounts reflect the evolving financial needs of real people in real time. Retirees may need a monthly check. Other clients might need an unexpected windfall put to work with minimal disruption. Advisors have to make sure that these necessary cash flows don't derail the investment strategy. That requires careful planning and analysis—with rebalancing.

Attention To Detail

Any one of these elements might be manageable with a spreadsheet, but once you consider all the analytical hurdles in hundreds or thousands of accounts, it's clear that rebalancing software is essential for asset allocation. For the same reason computers can outmaneuver humans in chess, software can quickly analyze virtually limitless combinations of portfolio adjustments in search of something approximating the "best" set of available choices.

"If you do this daily, it doesn't get out of control; it doesn't become onerous," says Rick Adkins, president of the Arkansas Financial Group.

Although Adkins and his colleagues review client accounts every day, sometimes only one or two require rebalancing. It helps to know that 99% of portfolios don't require attention on any given day, since that allows you to quickly focus on the 1% that do.
So if the software seems superfluous, it isn't.

Paul Carroll of Efficient Wealth Management, which manages money with multiple custodians, says that before his firm adopted TRX software about two years ago, "We were winging it in trying to be more efficient.

"It wasn't until we ran the software side by side with our spreadsheets to see how much we were missing," he says. Now he uses TRX almost every day. He likes that the firm can customize the parameters and flag those areas in portfolios that need attention.

Michael Kitces, the director of research at Pinnacle Advisory Group, estimates that managing his firm's $1.1 billion in assets these days would require eight to 10 additional employees without his rebalancing software, iRebal. (The firm's AUM is up roughly three times since iRebal was installed.)

"Without a doubt, iRebal software is the single greatest ROI for any technology investment we've had," says Kitces.

J.D. Bruce makes a similar point about iRebal. When Abacus started using the software in 2009, the firm had 350 clients and two full-time traders. Today, Abacus' trading staff is lighter by one while the number of clients has more than doubled to 750, in part because the firm was able to lower its account minimums from $1 million to $75,000. "Without iRebal, we couldn't do that," Bruce says.

But software is only as productive as the inputs received, which means advisors must codify and formalize their investment strategy. Transitioning to this software could be challenging for those who run money without a formal plan. The software requires you to be fairly specific. You must choose tolerance ranges for asset weights, for example, and set minimum dollar amounts for trades, outline tax-related parameters and create brokerage instructions for limit-order ranges, just to name a few things.

Whether or not you have the software, your design and oversight of asset allocation is too important to be left to fuzzy thinking and vague plans. That's especially true in a world where portfolios are invested in ever more far-flung corners of the global markets with ETFs. As portfolios take on a broader mix of risks, it's crucial that the analytical engine for managing these risks is up to the task.

Rebalancing isn't a silver bullet, of course. A poorly designed strategy isn't going to improve your performance if you simply automate the analytics. But if you have a reasonable set of rules, computerized rebalancing will go a long way toward keeping your firm competitive on the frontline in the investment wars.

By contrast, if rebalancing software isn't part of your practice, you'll almost certainly face growth limits, and perhaps sooner than you expect. "Manual trading and rebalancing are not scalable," Kitces observes.

Rebalancing software also helps you unlock the full potential of data unique to your firm: client asset allocation information. Yet the tool is still widely overlooked. "Many more advisors could benefit from intelligent rebalancing software than are using it today," says Bruckenstein.
