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Rebalancing can improve investment outcomes

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Wealth managers are realising that the expected rates of return for the next 10 years will be substantially lower than the past decade. Valuations of all financial asset classes are near all-time highs on many measures and the risk-free rate of return is at historic lows.

RBA research shows that the implied equity risk premium (excess return over risk-free assets) was about 4 per cent over the past century. Yet in the 10 years to July 2020, Chant West's research shows the average growth portfolio, defined as holding between 60-80 per cent growth assets, returned 7.5 per cent a year.

Today, it's a different story, with the current 10-year Australian government bond rates hovering around 1 per cent, the expected return from a simple 60/40 (equity/bond) portfolio may be about 3.5 per cent a year.

It means financial planners and investors will need to build more robust portfolios to contend with lower growth from asset class returns, valuation and market risk, and potential inflation to meet investment objectives. Alternatives will become more attractive to meet some of the expectation gap from asset class returns, but trade-offs in liquidity and complexity will limit large-scale use.

Better solutions will be those strategies that can deliver added sources of alternative return without the typical complexity, cost or illiquidity associated with "alternative

products”. Multi-asset portfolios designed to take advantage of straightforward portfolio rebalancing on a systematic basis is one area of low-hanging fruit.

The market volatility in the first quarter of 2020 was a painful reminder for many of the risk inherent with high-growth portfolios. As in many systemic market and liquidity events, most portfolio diversification benefits break down except for core defensive holdings (cash, gold, government bonds and other explicit tail risk/alternatives).

But for specialist multi-asset portfolios this volatility presents opportunity; those holding enough defensive assets could buy equities in March. But for most superannuation funds this was not an option for the following reasons:

- Portfolio construction typically holds high levels of assets tied to growth. Most MySuper options and balanced portfolios hold 60-80 per cent of assets in diversified growth assets.
- Illiquid assets – high allocations to credit and private markets restrict the ability to rebalance those holdings. Illiquid asset pricing is typically inefficient in stressed periods.
- Investment committee process – reacting to significant portfolio opportunities can be frustrated by approval processes.

In retail, most SMA and model portfolios are not designed to take advantage of this volatility. Although retail will hold mostly liquid assets, for many rebalancing usually entails a time-determined period (e.g. quarterly). As the first quarter of 2020 highlighted, markets can swing wildly inter-month and even inter-week.

Unless you are a professional seeking to harness volatility in a rules-based way, the strategy is not easily employed. Rebalancing is counterintuitive (selling winners/buying losers) and managing for execution costs and tax is critical to success. For investors with small balances, this is usually restricted further as they are typically suboptimal to rebalance efficiently.

More importantly, for most financial advisers and accountants, their primary value proposition for clients is tax management and designing investment strategies to meet long-term objectives, not day-to-day investment management processes. Portfolio rebalancing is not a primary reason to sign up an accountant.

For advisers seeking to add alternative sources of return in the future, the ability to harness volatility via rebalancing is attractive on several levels:

- Not complex and utilises liquid exchange-traded instruments;
- Does not rely on adding higher levels of equity, illiquidity, or credit risks;

- Opportunity for added return increases as volatility increases;
- Not correlated to traditional portfolio construction.

Cor Capital's systematic approach to portfolio rebalancing can be a significant contributor to performance. The portfolio is fundamentally diversified for all economic scenarios (growth, recession, inflation and deflation), holding equal physical weights to cash, bonds, growth (listed equities) and precious metals (physical gold), all highly liquid assets. This asset allocation captures broad asset class exposures and lower volatile trends but critically is able to harness volatility, ensuring its overall returns have outperformed most superannuation funds on return and drawdown metrics.

Performance Cor Capital Vs. Superfunds (Chant West) (Jul 31, 2020)

Fund Category (% Growth Assets)	1 yr (%)	3 yrs (% pa)	5 yrs (% pa)
Cor Capital Fund	**11.62**	**6.54**	**6.79**
All Growth (96-100%)	-2.7	6.4	6.1
High Growth (81-95%)	-1.7	6.3	6.2
Growth (61-80%)	-0.9	5.6	5.7
Balanced (41-60%)	-0.2	4.8	4.6

Source: FundLab, Chant West, Cor Capital

This performance helps explain why Cor's investment approach appeals to HNWs and SMSF investors who are drawn to its defensive-first mindset and focus on capital protection, as well as a strategy that captures periods of volatility for added return and low correlation with their traditional holdings.

As advisers, accountants and investors face an uncertain world, the high-growth strategies of superannuation and other investment portfolios will be challenged. Adding illiquidity premia may be useful for institutions wanting higher returns, but the cost factor makes it a questionable strategy for advisers and their retail clients. Instead, they will need to build more asymmetric portfolios to increase the probability of meeting their clients' longer-term investment objectives.

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