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Rebalancing in a Time of Volatility

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With the sharp decline in equities worldwide, many institutional investors find themselves overweight fixed income and underweight equities. In many cases, strategic policy ranges set by the long-term planning process have been breached. Given all of the uncertainty and market volatility, many of our clients are wondering what to do next. Should the portfolio be rebalanced? How should they manage their liquidity needs when liquidity comes at a premium?

(Estimated reading time: 6 min 37 sec)

When emotions run high, committing to your long-term strategic asset allocation policy can be difficult. At Callan, we believe that following a disciplined approach and rebalancing is ultimately a risk mitigator. Yes, the practice may have the potential to enhance return (buy low, sell high), but the primary reason is to control risk. Your adopted policy is the ultimate expression of your risk tolerance.

Before moving on to rebalancing, understanding your liquidity needs is the critical first step. Investors of all types should clearly define and understand future liquidity needs in the short to intermediate term, and then identify the current sources of liquidity available in the portfolio.

With that backdrop, investors need to develop a plan for meeting short-term cash needs:

- Is there adequate liquidity to make benefit payments or promised distributions in the short term?
- What are anticipated receipts (i.e., contributions, dividends/interest, rents, distributions, donations)?
- What about other expenses?
- How will the investor handle capital calls from private markets?

As investors consider rebalancing, the exercise should be viewed with an eye toward meeting the identified liquidity needs first, while getting the portfolio back to its asset allocation policy target.

Practical considerations to rebalancing in a turbulent market

Be mindful of market conditions. A successful rebalancing strategy strikes a balance between maintaining a desired level of risk and incurring increased transaction costs. Current market uncertainty has impacted liquidity and the cost of transacting.

Fixed income markets are functioning, but bid/ask spreads have definitely widened. Trading in the Treasury market is more expensive than normal, but more liquid than corporates and structured products like asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS).

When should you rebalance?

We believe that you should rebalance whenever your policy calls for you to do so. Most institutional policies employ ranges around target allocations, and rebalancing is triggered when the portfolio is outside of these ranges. However, practical considerations need to be woven into the process.

If the cost of transacting is prohibitive, or if you are not comfortable with rebalancing now, you can choose to temporarily suspend the policy. In such a case, it is important to document why you are suspending the policy and when you would resume following it. In addition to cost, concerns can stem from operational considerations.

Suspending the policy poses a risk of misalignment of the portfolio with risk tolerance and imposes market timing on the decision of when to resume.

How to implement rebalancing?

Communication among providers is critical. Reach out to managers (as well as recordkeepers and custodians) as soon as possible. Ideally, leave as much lead time as practical to effect transactions.

With all of the cautions in mind, we are encouraging investors to rebalance as appropriate after carefully considering their circumstances:

- **Standard practice:** Take the money from the asset class that is most overweight and has liquidity at the time. Supplement with available cash flow if possible (income, dividends).
- **Complementary practice:** Tap the most-appreciated assets (if liquid).
- **Complications:** There may be temporarily constrained liquidity/higher transaction costs in liquid assets, or the inability to rebalance illiquid assets, or additional assets may be needed to fund capital calls from illiquid assets. Overlay solutions can help raise cash to use for liquidity needs and rebalancing, but the program has to be in place to be accessed.

How far back should you rebalance? Enough to just get back within the rebalancing range or all the way back to target? What about halfway back?

Investment theory suggests all the way to target. Practical considerations and cost, along with some research, suggest a benefit to halfway back, but circumstances can vary (e.g., cost, other exposures). Here are some questions to consider in evaluating this decision:

- What do other priorities for the portfolio dictate?
- How much are you willing to move given market volatility and how often?
- Should you leave some liquidity available for another time in the future given the uncertainty?

<u>Corporate DB Considerations</u>

For corporate defined benefit (DB) plans on a de-risking glidepath, most paths are one direction. Should you consider re-risking?

- If you don’t have a re-risking policy in place, we do not believe this is the time to craft one.
- The potential range of outcomes is too wide and probably carries too much downside risk. If you feel that you’ll be compensated for the risk, consider that it is more likely you’ll be catching a falling knife while the markets remain unsettled.

For benefit payments, make requests across managers so that each manager can tap the most liquid part of their portfolios. Should you consider a cash set-aside for benefit payments? The plan can certainly do so, but setting one up creates the same issues as rebalancing regarding incurring transaction costs. You also need to be mindful of altering the risk profile of the plan with a cash allocation, and consider the funding source. Such liquidity balances are often set up in advance to accommodate this type of market situation.

Nonprofits/others with sizeable illiquid assets

Endowments, foundations, public pensions, and other investment pools with required outflows must be mindful of liquidity needs and sources for distributions and expenses. Hopefully, an investor with a large allocation to illiquid assets set up an investment program to also meet planned liquidity needs.

Wider rebalancing ranges are typical for illiquid strategies to accommodate market volatility and the inability to rebalance from these assets. Smaller liquid asset exposures and limited fixed income allocations are common among nonprofits, as well as some public DB plans with substantial private market exposures. Preservation of the liquidity provision may limit the ability of the fund to fully rebalance the underlying beta exposures.

DC considerations

Plan sponsors have built a strong team of service providers with business continuity plans; use them and don’t panic. Now is the time to rely on those you have hired and what they have built for times of stress. A DC plan sponsor’s job is to make sure there are open lines of communication. The priorities for keeping the plan up and operational are paramount.

- This blog post highlights the key functions a plan sponsor can check on and make sure all parties are prioritizing.
- If there are plan-level changes in process or being formulated, reassess whether they are “must haves” or “nice to haves” and the level of impact they may have.
    - Simple share class changes to pass along fee savings to participants should be an easy change and not impact market movements or involve participant blackout periods.
    - Bigger projects with illiquid or potential NAV disruptions may need to be put off to ensure proper execution of the transaction. Working with the incoming and outgoing investment manager is paramount, and as much notice as possible is the key. Even two weeks’ notice may not be enough given the size of the fund or the asset class.
    - Changes that may call for a participant blackout period should be delayed given the significant volatility so that participants can have access to their accounts.

This would certainly include changing recordkeepers or merging plans as an example.

The key message is to keep in good contact with all parties, and don’t be afraid to ask any question in these stressful times. Plan sponsors and participants are not alone. Plan service providers are set up for these events so prioritize the workflow to keep the focus on the core functions of the plan and perhaps delay those more elective projects for a time when stress, volatility, and basic everyday functions come back to normal.

Summary

We believe in rebalancing, and suggest institutional investors follow the practice if possible. Inventory and plan for liquidity needs, evaluate asset allocation relative to policy, identify sources of liquidity, be mindful of cost and operational requirements, and rely on the expertise of your service providers.