Morningstar Investment Management Insights
Rebalancing & Value Traps

Morningstar Investment Management
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For Financial Advisors and Their Clients Using Our Portfolios

Key Takeaways: Rebalancing Considerations

- Focus on long term performance to reduce any focus on short term returns and consequently enable patience as one can hold positions that are moving against them.
- Have formal and informal limits on the maximum amount of capital one can commit to positions in order to reduce the impact of errors.
- Peer review all convictions and investment decisions to try to avoid confirmatory bias.
- Actively seek contrarian positions by treating an asset class and its popularity as a negative relationship.
- Prioritise research over reaction. Undertake deep fundamental research in an attempt to identify potential value traps and avoid them.
- Beware of overnight experts and those making short-term forecasts.

Rebalancing Principles and Warren Buffett

Even if an investor has the perfect investment philosophy, there is still scope for error when it comes to execution. One of the key elements that any investor must consider when managing a portfolio is when and how frequently to *rebalance* back to *target* weights. While this subject is both important and hotly debated, we have found no academic work to support the view that there is an optimum rebalancing period. Therefore, while we remain open to the discovery of a reliable systematic approach to rebalancing, we believe that rebalancing requires significant thought and a best execution policy should be open to change.

The key element of a diversified portfolio is the fact that asset prices move in different directions, especially when allocating between negatively correlated assets such as equities and bonds. This aspect of capital markets can help reduce the volatility of a portfolio that is broadly spread across asset classes, although does reduce our exposure to our best ideas. By virtue, this can lead to a misalignment between the desired allocation and reality.

Rebalancing is therefore an essential part of a valuation-driven philosophy. Left unchecked, our exposures will not resemble our best ideas. Yet, executed too aggressively or regularly and we expose the portfolio to unnecessary turnover (taxes and fees) and the potential for drag. We have witnessed this in practice, with Warren Buffett a master but countless others failing miserably as they seek to top-up positions that are in structural decline.

"Averaging Down" is Simple but Not Easy

The subject of averaging down is one of the biggest challenges for valuation-driven investors to tackle. In essence, it is the art of obtaining the lowest cost base possible. For example, say an investor buys an asset today and it falls by 40% tomorrow. Should they buy more of it?

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For value investors, the general wisdom is that you should definitely buy more so long as your conviction in the long-term fair value of the asset remains. It was this exact concept that Warren Buffett referred to when he famously said, "Whether we're talking about socks or stocks, I like buying quality merchandise when it is marked down".

At this point, it is worthwhile reminding that as a valuation-driven investor, you conform to the basic principle that you might be early to the party. After all, you are buying an investment today because there are more willing sellers than willing buyers.

Value Trap Identification & Behavioural Science

Of the major behavioural deficiencies we experience, the most important for value trap identification are likely to be the endowment effect and overconfidence. Specifically, investors tend to overvalue what they already have and this often skews their assessment of the resulting news flow. This is often due to overconfidence in the original buying decision and therefore less likely to change our assessment of fair value as it evolves. Said simply, we seek confirmatory evidence to support our view that something is cheap.

However, we must also be aware of the availability bias that tends to lead humans to extrapolate current trends. The more an asset price falls, the more likely we are to sell. Therefore, the worst situations occur when an impatient investor aggressively adds to a position in the early stages of a decline and then loses confidence at the lowest point, maximising the permanent loss of capital.

Said simply, the endowment effect can be damaging as we view fair value, while the availability bias causes us to ignore any fair value calculation. Both biases must be controlled if an investor wants to successfully and consistently identify value traps.

Bringing This Into a Rebalancing Policy

The major lesson from the above is that an auto-rebalance policy can be a potentially dangerous policy. It is what we would consider "lazy" portfolio management as it leaves end-investors open to significant transaction costs as well as value traps.

Therefore, given these weaknesses, we believe portfolios should not be subject to rebalance schedule as such. Instead, portfolio managers should be provided with the tools and accountability to monitor portfolios continuously and have the ability to make rebalancing decisions when appropriate.

Before any transactions are made, the assessment should include both quantitative and qualitative analysis of the portfolio to make sure it continues to reflect the best thinking and avoid unnecessary turnover. Investing is all about harnessing the long-term power of compounding.

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