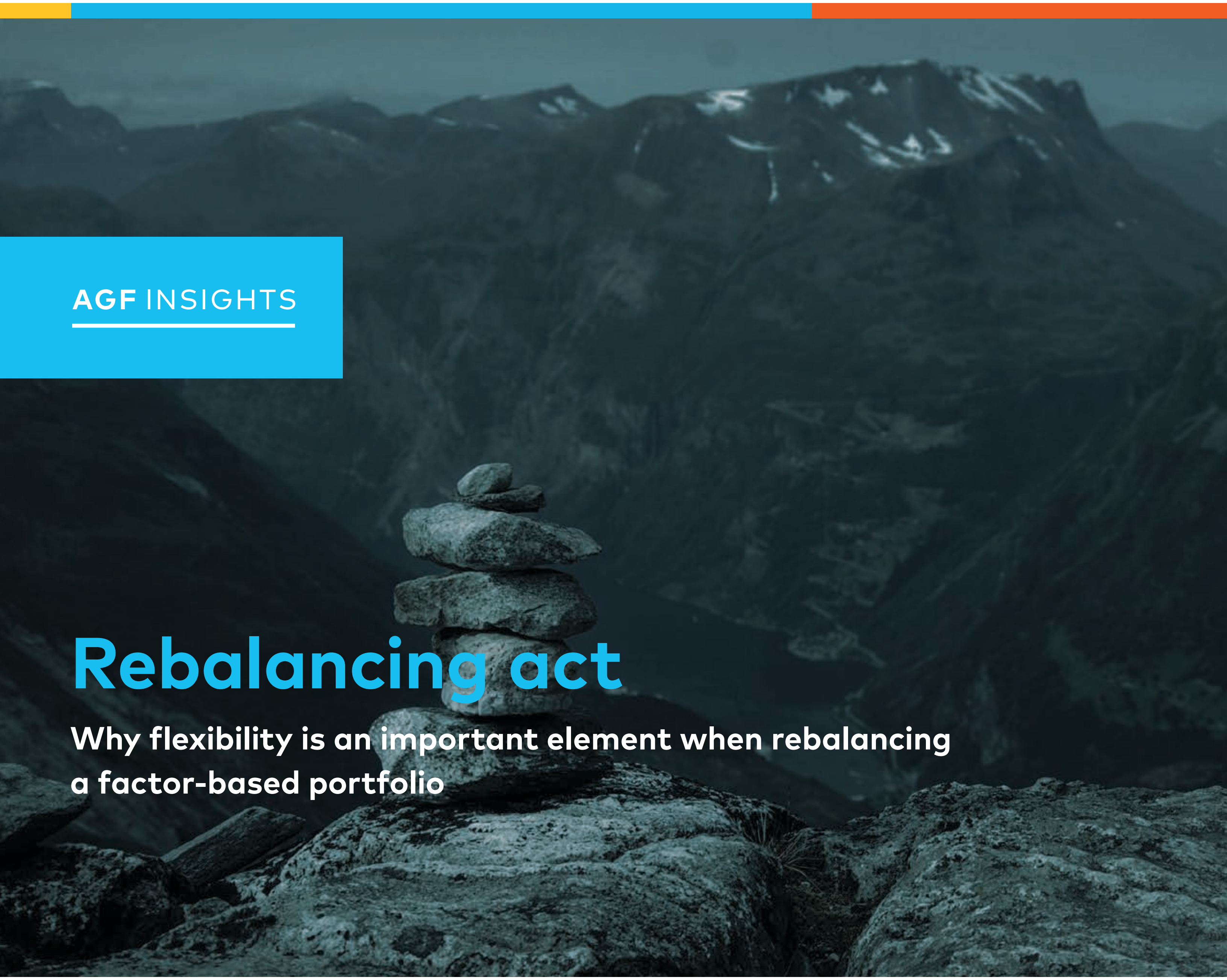

AGF INSIGHTS

Rebalancing act

Why flexibility is an important element when rebalancing a factor-based portfolio

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Most investors recognize the value in rebalancing their portfolios on a regular basis. After all, doing so can help rein in risk and generate extra return over time. But not everyone gets the degree and timing of it right, which can lead to outcomes that undermine the potential benefits.

This is especially true when it comes to factor-based investing, where the characteristics that define a security may change dramatically over time. While fluctuations in factor exposures are mainly random from day to day, it is crucial that investors plan for and adapt to longer-term shifts related to the erosion in information used to forecast future stock returns.

Also known as factor decay, this erosion is an unavoidable consequence of a dynamic market that can be anticipated to some extent by analysing average decay rates historically associated with factors such as momentum, value, quality, size and volatility. Often enough, however, actual rates of decay will deviate significantly from the mean and cannot be forecast in advance.

Fixed rebalancing frequencies and turnover levels, as a result, can be a great way to capture historical averages, but may miss the mark otherwise. As such, investors are better equipped to ensure factor exposures are aligned with ongoing intentions when they have the discretion and flexibility to rebalance and turn over a portfolio as needed.

Still, that's only part of the battle. Investors must also decide whether the benefits of taking action outweigh the costs of doing so.

In AGFiQ's case, that decision is grounded in our quantitative models that optimize factor exposures but then is further enhanced when the science of portfolio management meets the art of portfolio management.

More specifically, we incorporate mean variance analysis to rank each security in a given universe based on the potential rewards and risks associated with them. Those with the highest scores are then overweighted in the portfolio and those with the lowest scores are underweighted.

This is a powerful framework that can rank securities on a daily basis – and therefore know how an "optimal" portfolio should be recomposed almost all the time. And yet, herein lies one of the biggest challenges facing investors.

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The cost of rebalancing an actual portfolio this frequently would far outweigh the benefits in all but the most extreme scenarios. On the other hand, a rebalancing regime that is too infrequent can lead to unintended exposures that persist over extended periods of time and compromise the portfolio's mandate.

Similarly, turnover levels need to provide an expected benefit exceeds the cost of making the trades.

This dilemma can be addressed in large part by understanding why a stock or bond's score might change in the first place. As noted already, "noise" is one big reason, but the more important cause is the rate of factor decay inevitable in each security.

A momentum stock, for instance, is impacted by daily price movements and, therefore, doesn't usually exhibit its namesake characteristics for long. A value stock, meanwhile, is more influenced by quarterly earnings, not just daily prices, and tends to keep its spots longer. As such, momentum is commonly known as a high turnover factor, whereas value tends to require less frequent turnover.

Other factors, including volatility, size and quality, also have their own average rates of decay and fluctuation, using these estimates can be crucial in determining an appropriate rebalancing schedule. But whether that ends up being a quarterly rebalance with a turnover level of 25%, or something more or less frequent and of different magnitude, it can be dangerous to consider such a schedule as static. That's because the actual decay in a security's level of information rarely matches the average and, instead, tends to deviate from the mean more quickly or more slowly based on real-time circumstances.

In a multi-factor strategy, this can be further complicated by the dynamic interplay between factors. Correlations between momentum, value, volatility, size, and quality sometimes change, meaning the ability to get exposure to all of them is also subject to change. Therefore, If two or more factors move from correlated to highly uncorrelated over a short period of time, it may be necessary to rebalance out of schedule in order to avoid having negative (or not enough) exposure to one or more of the factors.

With all of this in mind, it's important to have some way of monitoring the difference between the strategy's optimal weights against their actual weights and then deciding how much of this gap can be tolerated. This could be as simple as creating a rule around what's generally acceptable and, more often than not, these gaps are small enough to ignore and/or can be easily rectified by regular inflows and out.

But in those cases where the portfolio has deviated too much from the optimal and flows are limited, the best action to take is often a swift and timely rebalance to bring it back in line.

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Bill is co-founder of AGF Investments LLC, a Boston-based investor advisory firm founded in 2009 and subsidiary of AGF Management Limited. He is a leader of AGF's quantitative investment platform, known as AGFiQ. AGFiQ's team approach is grounded in the belief that investment outcomes can be improved by assessing and targeting the factors that drive market returns. Bill has long-tenured expertise employing quantitative factor-based strategies and alternative approaches to achieve a spectrum of investment objectives.

Previously, Bill was a Vice-President at State Street Global Advisors (SSgA), serving as head of the firm's U.S. Enhanced Equities team. His focus was on managing long-only and 130/30 U.S. strategies, as well as providing research on SSgA's stock-ranking models and portfolio construction techniques. Prior to joining SSgA in 2003, Bill was a Quantitative Analyst and Portfolio Manager at Putnam Investments. Bill has been working in the investment management field since 1995. Prior to 1995, Bill was a Naval Aviator flying the Grumman A-6 Intruder as a member of Attack Squadron Eighty-Five aboard the USS America (CV-66).

Bill holds a Bachelor's degree in Electrical Engineering from the United States Naval Academy and an MBA from the Amos Tuck School of Business Administration at Dartmouth College. He is a CFA® charterholder and holds FINRA licenses 7, 63 and 24.

For more information, please visit AGF.com.

*An investment professional with AGF Investments LLC (formerly FFCM LLC), a U.S.-registered investment advisor firm and affiliate of AGF Investments Inc.

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