



Rebalancing

Ignore the Crowd... Follow Your Policy

March 2020

For Professional Clients Only

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Key points

- In stressed markets, investors are distracted by media noise and often trapped by the behavioural financing of the crowd.
- This note summarizes two reasons why disciplined rebalancing is the right strategy.
 - It helps investors to stay focused on long-term policy.
 - Timing markets is costly while rebalancing outperforms drifting strategy in prolonged bear markets.
- We recommend investors explore opportunity allocations and use Medium-Term Views to guide rebalancing.

Introduction

Voices in the media seem to be getting louder and louder with sayings such as “Why throw good money after bad?”, “Don’t try to catch a falling knife,” “Wait things out until the market settles down.” These statements seem logical, which is one of the reasons why they gain such traction. Especially when the momentum of the stock market appears headed one way (down) and every piece of news that comes out seems much worse than the last. Not only do the shouts from the crowd give investors cause for concern, but the field of behavioral finance demonstrates that our own innate human tendencies work against us as well, as most individuals exhibit the bias of extrapolating recent events well into the future.

Aon continues to advocate that most of our clients follow a disciplined, policy-oriented rebalancing strategy. Two of the primary reasons for this stance are:

1. Stay Focused on Long-Term Policy

Our clients typically have long-term time horizons and their strategic asset allocations reflect such time horizons. If the appropriate equity allocation for an institution is 50%, for example, then the institution should have 50% in equities, not 43% or 57%, etc. Said differently, if we see our clients take the brunt of a market decline, we also want to see them get the full benefit of a rebounding market, take advantage of dislocated financial prices, and implement opportunistic allocations, whenever the eventual turnaround occurs.

2. Timing Market Can be Costly

By and large we do not believe market timing is a successful endeavor. Unfortunately, the market does not loudly sound the “all clear” horn when things are about to get better and the market is ready to resume its upward march. As shown in Table 1 and Graph (see overleaf), missing the best week of returns during the recovery from a bear market can have a dramatic impact on performance.

Table 1: Historical Bear Market Cycles Since 1970

Market Peak (High)	Market Trough (Low)	Peak to Trough Unannualized Performance*	Recovery (Back to Previous High)	Trough to Recovery Unannualized Performance ¹	Best One Week Period During Recovery ²	Best One Week Performance ²	% of Recovery From Best Week ²
December 1972	September 1974	-42.74%	March 1976	79.28%	Jan 31, 1975	12.86%	16.22%
December 1976	February 1978	-17.83%	October 1980	21.65%	Mar 31, 1978	8.67%	40.07%
August 1981	August 1982	-19.64%	October 1982	24.29%	Oct 11, 1982	6.97%	28.71%
February 1985	September 1985	-18.92%	February 1986	23.85%	Dec 11, 1985	4.85%	20.35%
August 1987	December 1987	-30.92%	May 1989	44.98%	June 3, 1988	5.66%	12.59%
December 1989	October 1990	-36.48%	February 1993	58.03%	Sep 21, 1992	9.82%	16.92%
June 1991	August 1992	-19.51%	October 1992	24.39%	Sep 21, 1992	9.82%	40.26%
July 1998	October 1998	-23.43%	January 1999	31.60%	Oct 15, 1998	7.07%	22.36%
September 2000	March 2003	-53.85%	March 2013	117.28%	Mar 18, 2003	10.63%	9.06%
October 2007	March 2009	-40.13%	December 2010	67.84%	Mar 12, 2009	9.53%	14.05%
April 2015	August 2015	-16.90%	June 2016	22.55%	Aug 28, 2015	6.91%	30.64%
August 2018	December 2018	-16.34%	June 2019	19.71%	Dec 31, 2018	4.34%	22.03%

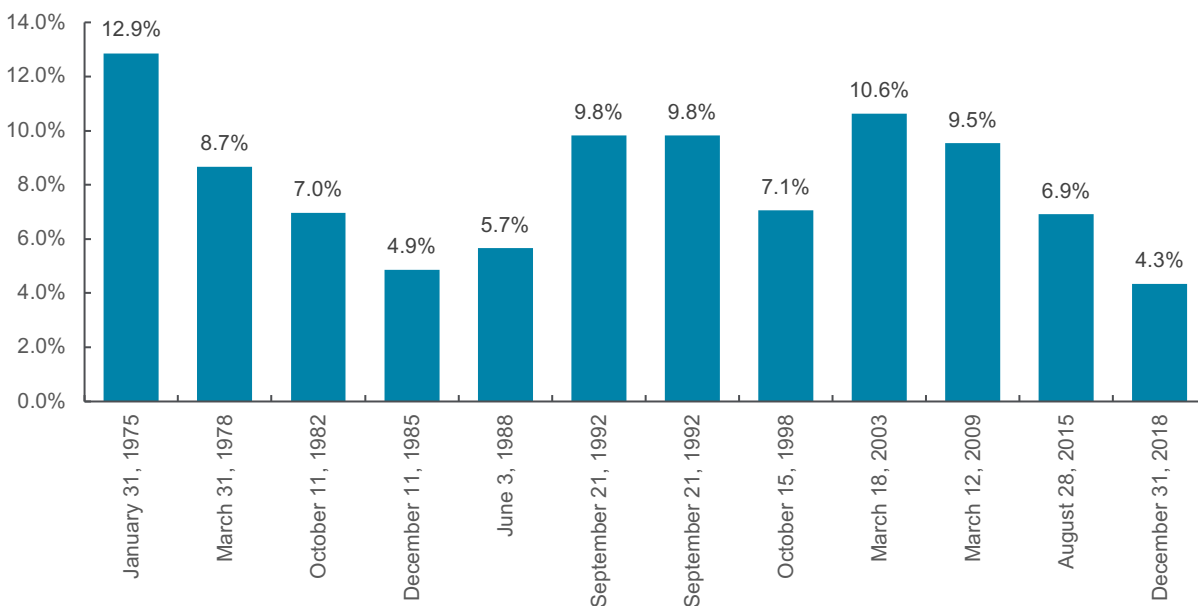
¹ Performance is based on MSCI World Price Index Return (not the Total Return Index).

² One Week is defined as 5 consecutive trading days.

Source: MSCI World.

Past performance is not a guide to future performance.

Graph 1: Recovery in Just One Week



Source: MSCI World

The events unfolding in the markets are truly monumental, whether it is a pandemic that spreads around the world, or a crushing crude oil price war. We're certainly not debating that point. We note, though, that there have been many historic events in the past as well, whether they be the Great Depression, wars, severe stock market crashes and sell-offs (October '87, Asian Contagion, the Tech Bubble Collapse, 9/11, Financial Crisis in 2008 etc.). Eventually, markets recover as shown in Table 2, and we believe those that have the conviction to remain within their policy allocations are more likely to outperform those that don't. Rebalancing to the long-term strategic allocation allows investors to participate in the ultimate recovery without risking missing the best weeks that could count for the big chunk of a renewed bull market.

Table 2: Duration and Severity of Historical Bear Markets

Peak	Trough	Time to Trough	Recovery	Time to Recovery
December 1972	September 1974	1 Year, 9 Months	March 1976	1 Year, 6 Months
December 1976	February 1978	1 Year, 2 Months	October 1980	2 Years, 8 Months
August 1981	August 1982	1 Year	October 1982	2 Months
February 1985	September 1985	7 Months	February 1986	5 Months
August 1987	December 1987	4 Months	May 1989	1 Year, 5 Months
December 1989	October 1990	10 Months	February 1993	2 Years, 4 Months
June 1991	August 1992	1 Year, 2 Months	October 1992	2 Months
July 1998	October 1998	3 Months	January 1999	3 Months
September 2000	March 2003	2 Years, 6 Months	March 2013	10 Years
October 2007	March 2009	1 Year, 5 Months	December 2010	1 Year, 9 Months
April 2015	August 2015	4 Months	June 2016	10 Months
August 2018	December 2018	4 Months	June 2019	6 Months
Average		1 year		1 Year, 11 Months

Source: MSCI World

We tested two portfolios starting at a split of 60/40 between equity (S&P) and fixed income (US investment grade) over multiple historical bear markets that have lasted more than one year. Portfolio A rebalances on monthly basis to its target allocations while Portfolio B drifts with the markets. Over all bear market cycles tested, the disciplined Portfolio A has outperformed a drifting portfolio B as shown in Table 3. Of course, there may be those that call the market correctly and get out and back in at right time. We note that doing so requires making two correct decisions – when to get out and when to get back in.

Table 3: Rebalancing Helped in Bear Markets

Market Peak (High)	Market Trough (Low)	Recovery (Back to Previous High)	Starting Value at the Peak	Rebalanced Portfolio at the End of the Cycle	Un-Rebalanced Portfolio at the End of the Cycle
August 1929	June 1932	December 1944	\$1,000,000	\$1,613,582	\$1,376,983
November 1968	May 1970	March 1972	\$1,000,000	\$1,207,810	\$1,199,369
January 1973	October 1974	July 1980	\$1,000,000	\$1,508,309	\$1,474,515
November 1980	September 1981	November 1982	\$1,000,000	\$1,300,331	\$1,296,684
March 2000	October 2002	May 2007	\$1,000,000	\$1,401,198	\$1,379,608
October 2007	March 2009	March 2013	\$1,000,000	\$1,270,614	\$1,245,958

Source: S&P

Past performance is not a guide to future performance.

How to rebalance?

In times of rising volatility in the equity markets, the correlations among various asset classes could jump to abnormally high levels. The panic selling in equity could even drive down prices of defensive assets and enlarge risk premiums of many non-equity assets. We encourage investors to stay calm and take advantage of market price dislocations to rebalance portfolios to a desired long-term target. Market volatility may make it difficult to move to the strategic allocations; thus, a phasing-in approach may be appropriate — moving back toward policy over a few consecutive weeks.

While we usually do not recommend large tactical positions based on the rationale described earlier, modest tilts toward more attractive markets — done within the bands of the investment policy — can add value. We see two main ways to do this.

The first is to apply tilts within the standard asset allocation categories in investment policies. Most investment policies have both target allocations and ranges, allowing this approach to be done in a risk-controlled way. Investors can transact explicitly to create the tilts, but often we see investors using these views more to affect how they rebalance and allocate cash flows — e.g. affecting whether to rebalance to above or below target, where contributions should go, and what to sell when needing to fund cash outflows. Aon produces Medium-Term Views to help with these types of decisions.

Another approach is to add an “Opportunity Allocation.”¹ An Opportunity Allocation is not an investment in and of itself; rather, it is part of an investor’s governance structure that helps facilitate the execution of great ideas in the portfolio. An Opportunity Allocation is flexibility built into the investment policy to enable investors to make investments that may not fit within a traditional asset allocation construct.

In summary, while it might feel tremendously difficult at the moment, we encourage clients to follow their rebalancing policies. Doing so requires the conviction to ignore the voices heard in the media (and potentially within our own heads) and maintain a steady hand, which for many will mean selling bonds, buying equities and being ready to take advantage of opportunities as they arise.

¹ Aon research: When Opportunity Knocks Again, March 2019

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Appendix: S&P Market Data

The charts shown previously have been replicated below using S&P data.

Table 1: Historical Bear Market Cycles Since 1948

Market Peak (High)	Market Trough (Low)	Peak to Trough Unannualized Performance*	Recovery (Back to Previous High)	Trough to Recovery Unannualized Performance ¹	Best One Week Period During Recovery ²	Best One Week Performance ²	% of Recovery From Best Week ²
May 1946	May 1947	-28.47%	June 1950	39.87%	May 21, 1948	7.21%	18.09%
July 1957	October 1957	-20.66%	September 1958	26.60%	Oct 29, 1957	4.39%	16.49%
December 1961	June 1962	-27.97%	September 1963	38.84%	Jul 5, 1962	8.00%	20.61%
February 1966	October 1966	-22.18%	May 1967	28.85%	Oct 18, 1966	5.03%	17.44%
November 1968	May 1970	-36.06%	March 1972	56.98%	Jun 2, 1970	12.34%	21.66%
January 1973	October 1974	-48.20%	July 1980	94.99%	Oct 11, 1974	14.12%	14.86%
November 1980	September 1981	-19.68%	November 1982	26.69%	Aug 23, 1982	11.55%	43.26%
August 1987	October 1987	-32.81%	July 1989	50.35%	Nov 2, 1987	12.33%	24.50%
July 1990	August 1990	-16.77%	February 1991	20.04%	Jan 21, 1991	5.94%	29.66%
March 2000	October 2002	-49.15%	May 2007	97.00%	Oct 16, 2002	10.72%	11.05%
October 2007	March 2009	-56.68%	March 2013	131.07%	Mar 16, 2009	11.43%	8.72%
October 2018	December 2018	-19.63%	April 2019	24.78%	Jan 2, 2019	6.76%	27.28%

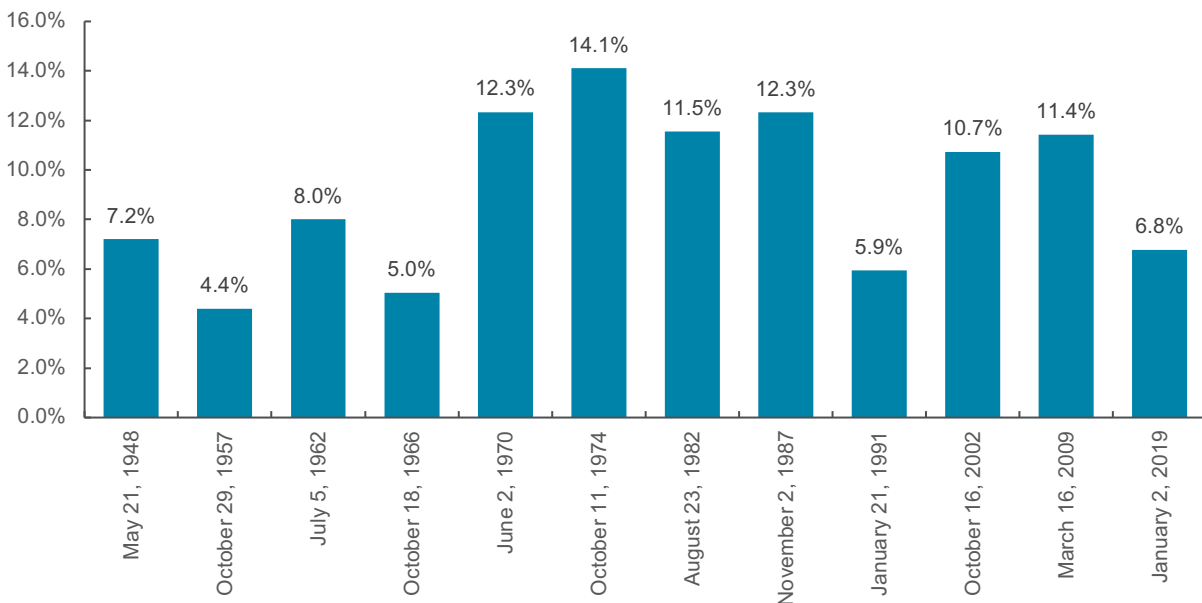
* Performance is based on S&P Price Index Return (not the Total Return Index).

** One Week is defined as 5 consecutive trading days.

Source: S&P.

Past performance is not a guide to future performance.

Graph 1: Recovery in Just One Week



Source: S&P

Table 2: Duration and Severity of Historical Bear Markets

Peak	Trough	Time to Trough	Recovery	Time to Recovery
May 1946	May 1947	1 Year	June 1950	3 Years, 1 Month
July 1957	October 1957	3 Months	September 1958	11 Months
December 1961	June 1962	6 Months	September 1963	1 Year, 3 Months
February 1966	October 1966	8 Months	May 1967	7 Months
November 1968	May 1970	1 Year, 6 Months	March 1972	1 Year, 10 Months
January 1973	October 1974	1 Year, 9 Months	July 1980	5 Years, 9 Months
November 1980	September 1981	10 Months	November 1982	1 Year, 2 Months
August 1987	October 1987	2 Months	July 1989	1 Year, 9 Months
July 1990	August 1990	1 Month	February 1991	6 Months
March 2000	October 2002	2 Years, 7 Months	May 2007	4 Years, 7 Months
October 2007	March 2009	1 Year, 5 Months	March 2013	4 Years
October 2018	December 2018	2 Months	April 2019	4 Months
Average		11 Months		2 Years, 2 Months

Source: S&P

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