Rebalancing

Ignore the Crowd...Follow Your Policy

March 13, 2020

Key Points

- There is a lot of uncertainty in the markets today
- Aon typically recommends a disciplined rebalancing process
  - It helps investors to stay focused on long-term policy
  - Timing markets is costly, and success is hard-fought; while rebalancing strategies usually outperform those strategies which don't rebalance in prolonged bear markets (and thus drift from policy)
- While rebalancing within their policy ranges, investors may also benefit from some market opportunities during market dislocations. An "Opportunity Allocation" is a way to embed this type of approach into an institutional investor's asset allocation structure.

Voices in the media seem to be getting louder and louder with concerns regarding COVID-19, the oil crisis, and ramifications of market volatility (all which are valid and bear notice).

However, they can lead to poor decisions with regard to your investment portfolio, 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 also the field of behavioral finance demonstrates that our innate human tendencies work against us, as most individuals exhibit the bias of extrapolating recent events well into the future.

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

1. Focusing on Long-Term Policy Provides Opportunities

Our clients typically have long-term time horizons, and their policy 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 rebound, taking advantage of dislocated financial prices, whenever the eventual turnaround occurs.

2. Timing Markets Can be Costly

Market timing is a difficult 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 1, missing the best week of returns during the recovery from a bear market can have a dramatic impact on performance.

The information contained herein is for informational purposes only. Nothing contained herein should be construed as legal or investment advice; please consult your investment professional for any such advice. This information has been obtained from sources believed to be reliable but is not necessarily complete and its accuracy cannot be guaranteed. Any opinions expressed are subject to change without notice.

Investment advice and consulting services provided by the entities listed on page 3.

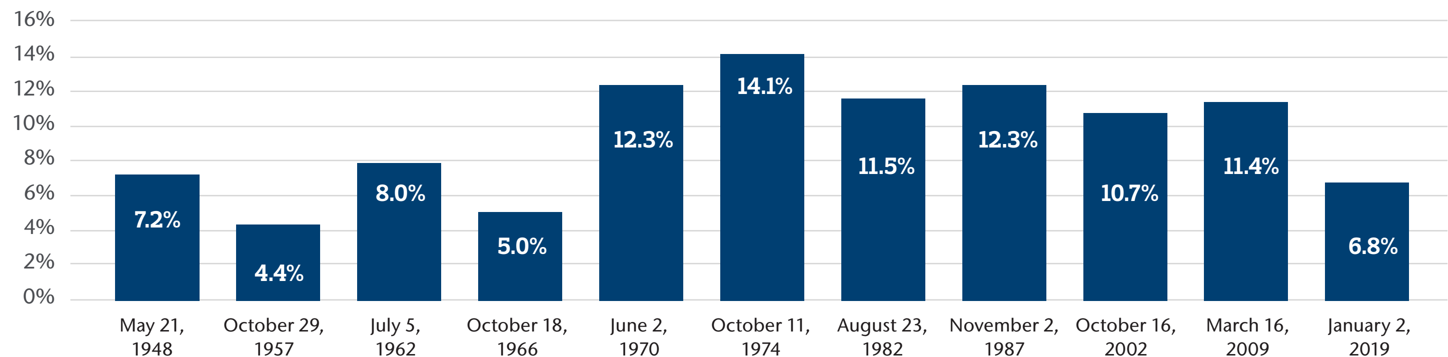
AON
Empower Results®

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	Best One Week Period During Recovery**	Best One Week Performance**	% of Recovery From Best Week**
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%	October 29, 1957	4.39%	16.49%
December 1961	June 1962	-27.97%	September 1963	38.84%	July 5, 1962	8.00%	20.61%
February 1966	October 1966	-22.18%	May 1967	28.85%	October 18,1962	5.03%	17.44%
November 1968	May 1970	-36.06%	March 1972	56.98%	June 2, 1970	12.34%	21.66%
January 1973	October 1974	-48.20%	July 1980	94.99%	October 11, 1974	14.12%	14.86%
November 1980	September 1981	-19.68%	November 1982	26.69%	August 23, 1982	11.55%	43.26%
August 1987	October 1987	-32.81%	July1989	50.35%	November 2, 1987	12.33%	24.50%
March 2000	October 2002	-49.15%	May 2007	97.00%	October 16, 2002	10.72%	11.05%
October 2007	March 2009	-56.68%	March 2013	131.07%	March 16, 2009	11.43%	8.72%
October 2018	December 2018	-19.63%	April 2019	24.78%	January 2, 2019	6.76%	27.28%

Source: S&P
Past performance is no guarantee of future results.
** Performance is based on S&P Price Index Return (not the Total Return Index)*
*** One Week is defined as 5 consecutive trading days*

Graph 1: Recovery in Just One Week



Source: S&P
Past performance is no guarantee of future results.

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 allocation ranges are more likely to outperform those that don't. Rebalancing to the long-term policy allocation range 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
May 1946	May 1947	1 Year	June 1950	3 Years, 1 Month
July 1956	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
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

Investment advice and consulting services provided by the entities listed on page 3.

We tested two portfolios starting at a split of 60/40 between equity and fixed income over multiple historical bear markets that have lasted more than one year. Portfolio A rebalances on a monthly basis to its target allocation while Portfolio B drifts with the markets. Over all bear market cycles tested, the disciplined Portfolio A has outperformed a non-rebalanced Portfolio B, as shown in Table 3.

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	$1,300,311	$1,296,684
March 2000	October 2002	May 2007	$1,000,000	$1,401,198	$1,379,608
October 2007	Match 2009	March 2013	$1,000,000	$1,270,614	$1,245,958

Source: S&P

Hypothetical returns are not necessarily indicative of future results and there can be no assurances that one will achieve comparable results. The hypothetical performance calculations are shown for illustrative purposes only, cannot be invested in and do not represent an actual client account. Hypothetical performance results have certain inherent limitations and unlike an actual performance record, they do not reflect actual trading, liquidity constraints, fees and other costs.

How to Rebalance?

In times of rising volatility, the correlation among various asset classes often increases. The panic-driven selling in equities could even drive down prices of defensive assets and increase risk premiums for many non-equity assets. We encourage investors to stay calm and take advantage of market dislocations to rebalance the portfolio to a desired long-term target range. Market volatility may make it difficult to move to the policy allocations or even trade efficiently; thus, a legging-in approach may be appropriate – moving back toward policy over a few consecutive weeks while making sure there's enough market liquidity to handle the trades.

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

The first is to apply tilts within the existing asset allocation categories in investment policies. Most investment policy statements 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 determine 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 statement to enable investors to make investments that may not fit within a "primary" asset allocation construct. Aon clients have used Opportunity Allocations for more than a decade, and these allocations have typically made a positive performance (and sometimes diversifying) impact during periods of dislocation when some niche strategies become attractive.

Conclusion

While it might feel tremendously difficult at the moment, most of our clients should follow their rebalancing policies. Doing so requires the conviction to ignore the voices heard in the media (and potentially within our heads) and maintain a steady hand, which for most will mean selling bonds, buying stocks, and implementing suitable opportunistic strategies.

Contact Information

Sudhakar Attaluri
+1.312.381.1321
sudhakar.attaluri@aon.com

Fei Amy Shang, CFA
+1.312.381.1329
amy.shang@aon.com

Eric Friedman, FSA, EA, CFA
+1.312.381.1319
eric.friedman@aon.com

Dave Keil, CFA
+1.847.442.5433
dave.keil@aon.com

Investment advice and consulting services provided by the entities listed on page 3.

[1] *Aon research: When Opportunity Knocks Again, March 2019*

Disclaimer

This document has been produced by the Global Investment Management Team, a division of Aon plc, and is appropriate solely for institutional investors. Nothing in this document should be treated as an authoritative statement of the law on any particular aspect or in any specific case. It should not be taken as financial advice, and action should not be taken as a result of this document alone. Consultants will be pleased to answer questions on its contents but cannot give individual financial advice. Individuals are recommended to seek independent financial advice in respect of their own personal circumstances. The information contained herein is given as of the date hereof and does not purport to give information as of any other date. The delivery at any time shall not, under any circumstances, create any implication that there has been a change in the information set forth herein since the date hereof or any obligation to update or provide amendments hereto. The information contained herein is derived from proprietary and non-proprietary sources deemed by Aon to be reliable and are not necessarily all inclusive.

Aon does not guarantee the accuracy or completeness of this information and cannot be held accountable for inaccurate data provided by third parties. Reliance upon information in this material is at the sole discretion of the reader.

This document does not constitute an offer of securities or solicitation of any kind and may not be treated as such, i) in any jurisdiction where such an offer or solicitation is against the law; ii) to anyone to whom it is unlawful to make such an offer or solicitation; or iii) if the person making the offer or solicitation is not qualified to do so. If you are unsure as to whether the investment products and services described within this document are suitable for you, we strongly recommend that you seek professional advice from a financial adviser registered in the jurisdiction in which you reside. We have not considered the suitability and/or appropriateness of any investment you may wish to make with us. It is your responsibility to be aware of and to observe all applicable laws and regulations of any relevant jurisdiction, including the one in which you reside.

Aon Hewitt Limited is authorized and regulated by the Financial Conduct Authority. Registered in England & Wales No. 4396810. When distributed in the U.S., Aon Hewitt Investment Consulting, Inc. (“AHIC”) is a registered investment adviser with the Securities and Exchange Commission (“SEC”). AHIC is a wholly owned, indirect subsidiary of Aon plc. In Canada, Aon Hewitt Inc. and Aon Hewitt Investment Management Inc. (“AHIM”) are indirect subsidiaries of Aon plc, a public company trading on the NYSE. Investment advice to Canadian investors is provided through AHIM, a portfolio manager, investment fund manager, and exempt market dealer registered under applicable Canadian securities laws. Regional distribution and contact information is provided below.

Aon plc/Aon Hewitt
Limited Registered office
The Aon Centre
The Leadenhall Building
122 Leadenhall Street
London
EC3V 4AN

Aon Hewitt Investment
Consulting, Inc.
The Aon Center
200 E. Randolph Street
Suite 700
Chicago, IL 60601 USA

Aon Hewitt Inc./Aon
Hewitt Investment
Management Inc.
20 Bay Street
Suite 2300
Toronto, ON M5J 2N9
Canada

Contact your local Aon representative for additional contact and/or registration information relevant to your local country if not included above.

© 2020 Aon plc

About Aon

Aon plc (NYSE:AON) is a leading global professional services firm providing a broad range of risk, retirement and health solutions. Our 50,000 colleagues in 120 countries empower results for clients by using proprietary data and analytics to deliver insights that reduce volatility and improve performance. For more information, please visit aon.com.

AON
Empower Results®