**The Challenge of Rebalancing**

By David L. Lawrence

Of the many processes and/or procedures performed by financial advisory firms, investment rebalancing is arguably the most time-consuming and offers the greatest risk of inefficiency. One of the reasons why this may be true is that many firms choose to perform rebalancing manually, often using rudimentary tools such as self-created Excel spreadsheets. Another reason could be the decision by some firms to customize results for each client’s accounts, rather than use pre-selected standards that would presumably apply to all affected accounts. Whatever the reasons, taking excessive amounts of time to perform tasks that could have been automated takes too long to accomplish and offers too many opportunities for errors and/or inconsistencies in the rebalancing process.

Many firms choose to create their own rebalancing systems, using manually executed procedures for each client. With repetitive tasks that require substantial detailed input of data, such procedures exposure the advisory firm to the risk of errors and inaccuracies in the trading process associated with rebalancing. Tax-loss harvesting is just one example of a rebalancing procedure that requires a high level of accuracy. It also requires a decision process on ‘who goes first’ if performed manually. Automated solutions typically enforce a strict procedure that would be defensible in an audit situation. And, most automated solutions offer the opportunity for tax-loss harvesting throughout the year, not just at the end of the year.

Required Minimum Distributions (RMDs) are another example of inefficiency when performed manually by advisors. Most advisors set aside time nearing the end of the year to perform such calculations. Yet, this may or may not be the most advantageous solution for the client, particularly, in cases where integrating RMD distributions into an overall income need situation coupled with the inevitable tax consequences.

The advantages of using an automated solution for rebalancing include the following:

1. **Streamlines the trading process by automatically applying the Advisor's strategy quickly and efficiently.**
   1. Automated rebalancing can produce trades that rebalance at the household level, calculate trades needed for cash management and propose tax loss harvesting trades all at the touch of a button.
   2. Gives the Advisor the opportunity to rebalance when appropriate (as in based on specific triggers), rather than merely based on the passage of time; for example quarterly or semi-annually. With specific triggers, rebalancing could be based on a specific out of balance requirements, such as a percentage applied to asset classes, etc.
2. **Enforces consistency in applying Advisor's strategy both by client and across clients.**
   1. Virtually eliminates trade errors - reducing costs and business risk associated with trade errors.
   2. Helps Advisors meet their fiduciary obligation by treating all clients fairly.  For example, the Advisor can harvest tax losses for all clients in less than one day vs. taking several days to process all clients - which can lead to some clients not getting the benefit of losses should the market turn during the extended manual process.
   3. Simplifies compliance through documented consistency and review process.
3. **Allows Advisors to add sophisticated tax saving strategies without increasing workload.**
   1. A good rebalancing software should automatically avoid short-term gains, specifically identify high-cost trade lots to minimize gain recognition, avoid wash sales and integrate location optimization (across household rebalancing) as well as identify opportunities and calculate trades for tax loss harvesting.
   2. A good automated rebalancing solution should also offer capital gain distribution avoidance, which allows Advisors to trade out high distributing funds for lower distributing funds without incurring offsetting gains.
   3. A rebalancing program should also calculate the tax benefits from applied tax-saving strategies and produce client-friendly reports to document those benefits.

**The disadvantages include:**

1. **Cost - both in terms of money, start-up effort and learning curve.**
   1. Sophisticated rebalancing software will cost money.  A firm considering automated rebalancing has to be prepared to spend money.  Obviously, the ultimate benefits must be expected to exceed costs. No matter how "simple" or "easy" software is, start-up effort and learning curve are part of the deal.
   2. A firm considering automated rebalancing has to be prepared to put in elbow grease and commitment.  Here, it is imperative to consider complexity, estimated implementation time, and functionality - in addition to cost - in relation to the firm's specific needs, budget and time availability.
   3. It is often difficult for Advisors to accept or believe that they need automated rebalancing - or that it can even work!  And, it's hard to want to spend time and money to fix something that isn't broken!
2. **Forces consistency and discipline.**
   1. This might sound like a good thing in theory, but in reality, it's tough!  Advisors are famous for individualizing strategies, allowing exceptions, changing directions, and/or wanting the flexibility of applying personal judgment at any given moment.  A disciplined structure requires forethought, some realignment of what's currently being done, and a commitment to stick with it.
   2. Consistency and discipline must be accepted and embraced by the whole team - including all the Advisors in the group.  This can be problematic both for decision-making and internal relationships.
3. **Raises the firm's standards - both internally and externally**
   1. Once automated rebalancing is in place, the Advisor will be inclined to hold his or her firm to higher standards.  With automation in place, it is common for the Advisor to look at clients' accounts more often.  After all, if you're able to keep portfolios more consistently rebalanced, why not look more often?  If there is a market dip, since it is possible to harvest losses for all clients, why not?
   2. Once the clients become aware of the value of tax loss harvesting, location optimization, etc., they become more informed consumers.  They will actually pay attention to tax efficiencies and expect their Advisor to stay on top of opportunities.  This requires a real commitment on the part of the Advisor, yet it is also a huge differentiator when showing current and potential clients the value of professional portfolio management.

According to Sheryl Rowling, CEO of Total Rebalance Expert ([www.trxpert.com](http://www.trxpert.com)), “it is critical in terms of profitability and growth to have a formal rebalancing program. It is very difficult to do portfolio rebalancing using spreadsheets or paper. If your firm needs consistency and (needs) to eliminate trading errors; then rebalancing is a must. Tax loss harvesting is difficult to do by hand if you have to choose which clients go first, etc.”

While there are many rebalancing programs from which to choose (Tamarac, i-Rebal, and the aforementioned Total Rebalance Expert, to name a few), consideration should be made in which solution best matches up with the way the advisor’s firm handles rebalancing and to degree of sophistication to be employed in the process. With any decision that involves substantial costs, installation, customization and employee training, weighing the costs against the benefits is always a good idea. However, in most cases, the increased efficiency and lower ongoing operational costs will far outweigh the initial costs and possible aggravation of setting up automated rebalancing.

**David L. Lawrence, AIF®**, is Co-Founder and President of Global Practice Network, a technology and consulting firm that provides professional practices, broker dealers and independent firms with comprehensive, profit-driven efficiency consulting, technology solutions and resources. For details, visit [www.globalpracticenetwork.com](http://www.globalpracticenetwork.com/).