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A Treat from Quarterly Rebalancing, and Shock and Awe from Europe

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Third quarter 2011 was reminiscent of the worst of the 2008 credit crisis in that it reintroduced the possibility of a total collapse of the global financial system. The seeds of this potential catastrophe were sown by the first-ever credit downgrade of the U.S. and ongoing concerns that the European financial system was on the brink of failure. Equities collapsed and fixed income prices surged as fear dominated investor sentiment.

However, these conditions created an extraordinary — and extraordinarily simple — opportunity for investors to capitalize on volatile markets as the quarter came to an end. The opportunity of which we speak is a near-passive technique called rebalancing.

Portfolios with automatic quarterly rebalancing would have snapped up beaten-down equity issues at the end of the third quarter while selling high-flying bonds; doing so not only moved these portfolios back to their normal asset allocations, it positioned them to profit handsomely from the equity market's sharp October rally. (While "automatic" may imply passivity, rebalancing is certainly an active measure on the part of the advisor or portfolio manager.) Less a strategy than a discipline, automatic rebalancing maintains a consistent risk profile for clients; investors rarely have the stomach to buy more of their worst-performing assets while selling their best-performing ones, but rebalancing forces this discipline upon them regardless of market conditions. Automatic rebalancing also

Executive Summary

- October's rally highlights the benefits of a disciplined quarterly rebalancing program.
- Rebalancing enables investors to capitalize on market volatility.
- Economic fundamentals are showing signs of life after summer's doldrums, while corporate America continues to exceed expectations.
- Europe appears to have built an effective "fence" around its debt problem.

Risk Assets Surged in October

Index	Wgt	Oct-11	YTD	2010	2009	2008	2007	1 year	3 years	5 years	10 years
Equity											
S&P 500	10%	10.9	1.3	15.1	26.5	(37.0)	5.5	8.1	11.4	0.2	3.7
S&P MidCap 400	10%	13.7	(2.1)	24.9	35.0	(37.3)	6.7	7.1	16.0	2.5	7.0
S&P SmallCap 600	10%	14.9	(1.8)	25.0	23.8	(32.0)	(1.2)	9.3	12.4	0.9	7.2
U.S. REITs	10%	14.2	4.8	23.5	21.0	(41.5)	(20.2)	6.6	11.2	(5.7)	7.7
EAFE	10%	9.6	(6.4)	8.2	32.5	(43.1)	11.6	(3.6)	10.4	(1.9)	6.2
Emerging Markets	10%	16.0	(14.1)	9.8	93.5	(59.3)	59.1	(13.3)	21.6	6.7	19.9
Average		13.2	(3.0)	17.7	38.7	(41.7)	10.2	2.4	13.8	0.4	8.6
Fixed Income											
Corporate	10%	1.8	8.0	9.0	18.7	(4.9)	4.6	6.1	15.8	6.9	6.2
U.S. Treasury 20+	10%	(4.5)	25.5	9.4	(21.4)	33.7	10.2	19.4	11.9	9.6	7.7
Global Aggregate	10%	1.3	6.8	5.5	6.9	4.8	9.5	4.1	9.6	6.9	6.9
High Yield	10%	6.0	4.5	15.1	58.2	(26.2)	1.9	5.2	23.0	8.0	9.2
Average		1.2	11.2	9.8	15.6	1.9	6.5	8.7	15.1	7.9	7.5
60/40 Portfolio		**8.4**	**2.7**	**14.5**	**29.5**	**(24.3)**	**8.8**	**4.9**	**14.3**	**3.4**	**8.2**

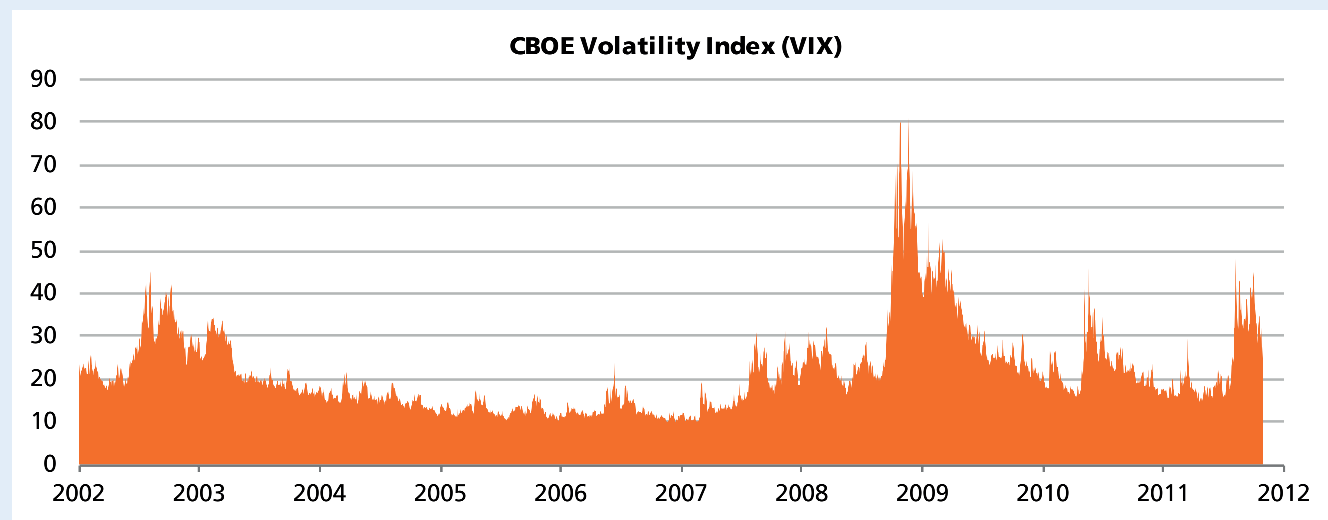
Source: MSCI, Standard & Poor's, FactSet

tends to exploit volatility by institutionalizing a contrarian buy low/sell high strategy, as we will explain later.

Before we show just how much an investor benefitted from rebalancing at the end of third quarter, we'd like to highlight the fundamental reasons that continue to favor equities over fixed income in the current environment. We have spent a lot of time in our previous notes discussing the two primary drivers of market performance: fundamentals and global risks. Fundamentals tend to be the main determinant of markets unless global risk reaches crisis levels, as it did in the third quarter. While the U.S. was able to recover its standing quickly following the credit downgrade, Europe's situation deteriorated further throughout the quarter. The U.S. recovered because it swiftly implemented effective monetary policy. Europe, on the other hand, dragged its feet for months before finally winning back the market's confidence with Merkel and Sarkozy's bank recapitalization plan, which thus far has been perceived as an effective "fence" to contain debt contagion.

With Europe seemingly under control, the market was able to turn its focus back to fundamentals, which had been marching forward all along. Within the first three weeks

Volatility Eased After Spiking in the Third Quarter



Source: Standard & Poor's, Chicago Board Options Exchange, FactSet

Corporate America Continues to Shine

Sector	Reported			Earnings Growth			Earnings Surprise		
	Actual	/	Total	Percent	Positive	Negative	Percent	Positive	Negative
Energy	33	/	42	56.6%	25	7	6.2%	22	11
Materials	27	/	31	32.2%	23	4	6.5%	22	5
Industrials	50	/	59	17.4%	44	5	4.5%	42	8
Consumer Discretionary	37	/	76	19.9%	29	7	0.9%	24	13
Consumer Staples	21	/	41	8.4%	17	2	1.5%	12	9
Health Care	44	/	51	6.7%	38	6	5.2%	36	6
Financials	67	/	81	9.6%	47	18	14.0%	43	24
Information Technology	51	/	75	17.9%	32	16	2.9%	42	8
Telecommunication	5	/	8	20.7%	2	2	5.5%	3	2
Utilities	19	/	33	7.5%	15	4	5.5%	17	2
S&P 500	354	/	497	18.9%	272	71	5.8%	263	88

Source: Bloomberg, Standard and Poor's, FactSet

Note: Earnings Growth is the percentage change in the cumulative share weighted EPS earnings from that of a year ago. Surprise Percent is the share weighted average of the ratio of actual company earnings vs. the consensus estimate.

of October there was an avalanche of positive data:

- ISM Manufacturing surprised with strong expansion, while Services continued its growth.
- Nonfarm payrolls for September came in at 103,000, double the consensus expectation.
- Retail sales also doubled expectations on higher "back to school" sales, which bodes well for the Christmas shopping season.
- Third quarter earnings thus far have extended corporate America's trend of outperformance; with 70% of the S&P 500 companies reporting, earnings growth is at 19% while top-line revenue is more than12%.

It got even better toward the end of the month, with a strong durable-goods report and stellar third quarter GDP numbers. This market simply got lured into a European bear trap, while the bulls were snorting in glee at the astounding fundamentals. As October drew to a close, equity markets flirted with a record monthly return while bonds pulled back. Short sellers were decimated, crippled by Europe's "shock and awe" plan that almost seemed specifically designed to inflict maximum pain on the bears while extracting the best deal from Greek bondholders.

The disciplined investor that rebalances quarterly benefited from riding the volatility and also profited from the incremental return from rebalancing that we call a "free lunch". In this market, a free lunch is definitely worth investigating.

To illustrate, let's compare the returns of a portfolio that rebalances quarterly with that of a rigid buy-and-hold portfolio. Let's assume a hypothetical diversified portfolio — 60% equity/40% fixed income, equally weighted across ten asset classes — was established on July 1, 2011. Fast forward to September 30, 2011; given the third quarter returns, equities would have dropped to 53.2% of the portfolio while bonds increased to 46.8%, allocations clearly out of step with the investor's original intentions and 60/40 positioning.

Rebalancing restores the weights of all of the asset classes to their original allocation. Comparing October returns for an unbalanced and a rebalanced portfolio illustrates the beauty of rebalancing — the rebalanced portfolio picked up 106 basis points in October alone. This is an annualized rate of 13.5% for the same initial investment, same strategy, same asset allocation.

This quarter is not a conveniently chosen example and certainly not unique. Volatility over the past few years (and even for the past decade) has been inescapable and at times frightening. However, investors always have had the tools to capitalize on volatility, and rebalancing is one of them. Rebalancing maintains a consistent risk profile for an investor and transforms volatility into an opportunity to earn incremental return through its disciplined application. Investing always implies volatility — rebalancing shows that volatility is a normal part of building wealth. ■

October Showcased the Benefits of Quarterly Rebalancing

Index	3Q Return	October Return	Buy & Hold Weights *	Oct Return w/ no rebalancing	Rebalanced Weights	Oct Return w/rebalancing
Equity						
S&P 500	-13.9%	10.93%	9.44%	1.03%	10%	1.09%
S&P MidCap 400	-20.2%	13.65%	8.75%	1.19%	10%	1.37%
S&P SmallCap 600	-20.1%	14.91%	8.76%	1.31%	10%	1.49%
U.S. REITs	-15.3%	14.19%	9.28%	1.32%	10%	1.42%
EAFE	-19.0%	9.65%	8.88%	0.86%	10%	0.96%
Emerging Markets	-25.8%	15.99%	8.13%	1.30%	10%	1.60%
Fixed Income						
Corporate	2.8%	1.79%	11.27%	0.20%	10%	0.18%
U.S. Treasury 20+	29.2%	-4.49%	14.16%	-0.64%	10%	-0.45%
Global Aggregate	1.0%	1.33%	11.06%	0.15%	10%	0.13%
High Yield	-6.1%	5.99%	10.29%	0.62%	10%	0.60%
Portfolio Return				**7.33%**		**8.39%**

No Rebalancing

Rebalancing

Source: Standard & Poor's, First Call, FactSet, ING Investment Management

Data as of October 31, 2011. The asset classes in the above allocation are represented by the following indexes: S&P 500, S&P MidCap 400, S&P SmallCap 600, MSCI U.S. REIT Index, MSCI EAFE Index, MSCI BRIC Index, Barclays Capital U.S. Corporate Bonds, Barclays Capital U.S. Treasury Bonds, Barclays Capital Global Aggregate Bonds, Barclays Capital U.S. High Yield Bonds.

**The weighting of each asset class at the end of the third quarter, reflecting the performance of the hypothetical portfolio since its July 1 start. For example, a $100,000 initial investment would have been worth about $91,000 at quarter end given the portfolio's 9.1% decline, while the initial $10,000 allocation to the S&P 500 asset class would have declined to about $8,600. Dividing the value of each asset class at quarter end ($8,600 in the case of the S&P 500) by the value of the portfolio ($91,000) we arrive at the new weighting for each asset class (9.4% for the S&P 500).*

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