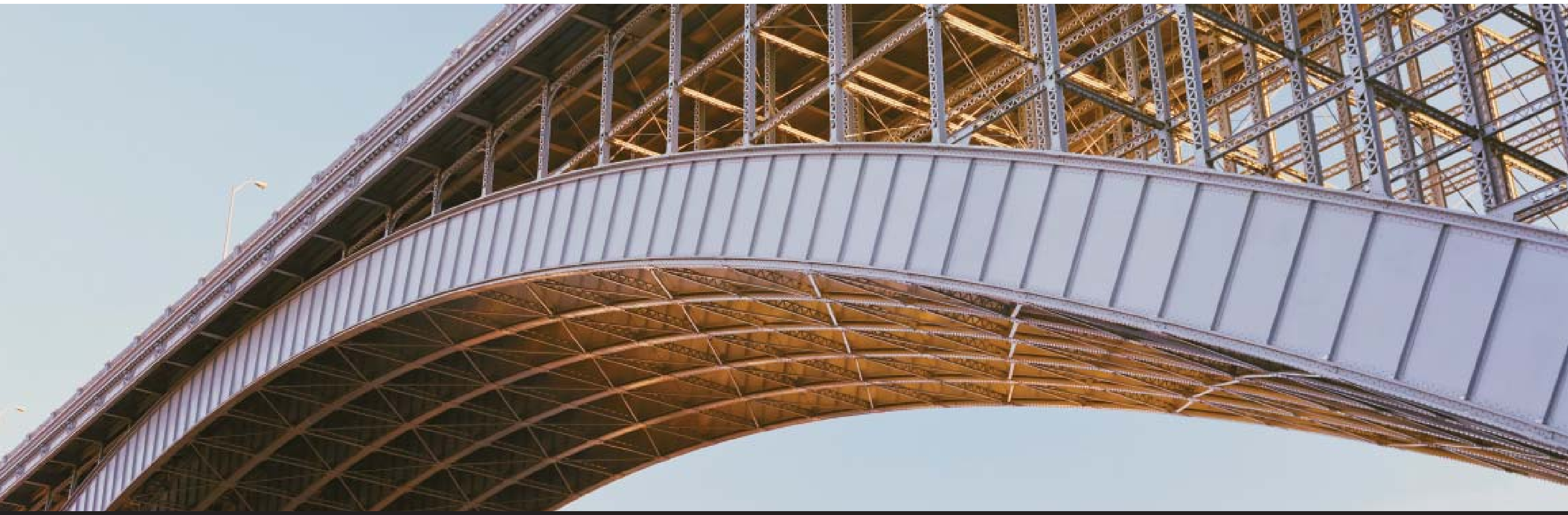
Systematic Rebalancing: Overcoming Human Nature

- Rebalancing can increase returns and reduce risk
- Investors know this, but emotions cloud their judgment
- We've developed a disciplined rebalancing strategy to keep you on track



AllianceBernstein
Investments

Building a Diversified Portfolio Is One Thing, Maintaining It Is Another

Investors receive a steady diet of advice on how to design effective investment strategies: what types of assets to consider, how they should fit together in a diversified portfolio, and even the percentage that each asset should represent.

But building a diversified portfolio is only half the story—maintaining its structure is just as important. The assets in our portfolios behave in different ways, and this can be a source of strength. But as some assets outperform and others trail, the portfolio mix that we've selected so carefully can also be thrown out of balance.

Learn From the Pros

When it comes to maintaining a balanced portfolio, investors can learn something from professional investors—large institutions, endowments and foundations. They consistently rebalance their portfolios to bring allocations back in line with their original design.

How does rebalancing work? Simply stated, rebalancing a portfolio means taking money from asset classes that have performed well and reinvesting in assets that haven't. If this concept seems familiar, it should. Rebalancing is based on the timeless investing adage, "buy low, sell high."

Why do institutional investors systematically rebalance? Because they've learned that a disciplined rebalancing strategy helps to maintain asset allocations and stay true to risk/return profiles.

Letting the winners run is human nature but it can undermine investors' objectives and increase portfolio risk.

The Dangers of Letting Capital Markets Run Their Course

To see how rebalancing works, let's look at the performance of two portfolios from 1990 to 2006—a period that witnessed the rise and fall of growth stocks in the late 1990s. First we'll see the impact on a hypothetical portfolio of letting the capital markets run their course. Then we'll examine how disciplined portfolio rebalancing could have helped.

Let's assume we started a portfolio with $100,000 in 1990 and divided it evenly between growth and value stocks, and then allowed the portfolio to run its course without rebalancing.

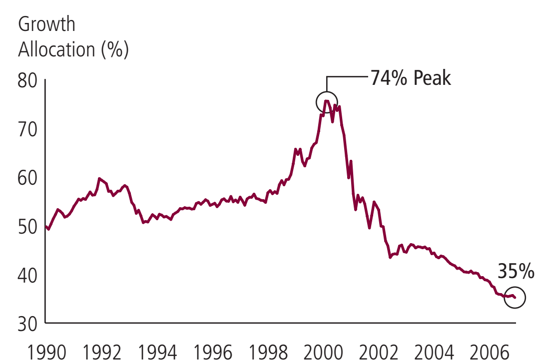
Through the 1990s, growth stocks beat value stocks and the portfolio's allocations became slightly skewed toward growth. As the growth cycle peaked in the last half of the decade, so did its growth-stock exposure—at a whopping 74%! Hindsight tells us that being left with only 25% in value stocks set us up for a fall, because in 2000 the style cycle shifted in favor of value stocks.

By the end of 2006, the most recent value cycle had taken its toll on the portfolio. Our growth stock exposure had declined to only 35%. We also ended up overweight in value stocks, with an allocation of 65%, even as the value-stock opportunity had declined to a historical low. All in all, we did pretty well, increasing our portfolio from $100,000 to almost $519,000, although it had peaked at $680,000.

With rebalancing, we could have done better.

Emotional Roller-Coaster: Failing to Rebalance Leads to Extremes

$100,000 Growth/Value Stock Portfolio (Initial Allocation 50/50)



Past performance does not guarantee future results. The above example is a hypothetical simulation using indices to represent the major asset classes. It is not representative of the returns of any investment, including any AllianceBernstein mutual fund. It is intended only as a demonstration of the potential benefit of portfolio rebalancing. Rebalancing methodology assumes one-way transaction costs of 50 basis points. There can be no assurance that rebalancing will achieve the intended results, and the costs of rebalancing may be significant over time. Growth and value stocks are represented by the S&P/Citigroup U.S. PMI Pure Growth and Pure Value indices through August 2006 and S&P/Citigroup U.S. PMI Growth and Value indices thereafter. Portfolio starting value is $100,000 on December 31, 1989. An investor cannot invest directly in an index. Please see back panel for index descriptions.

Source: Standard & Poor's and AllianceBernstein

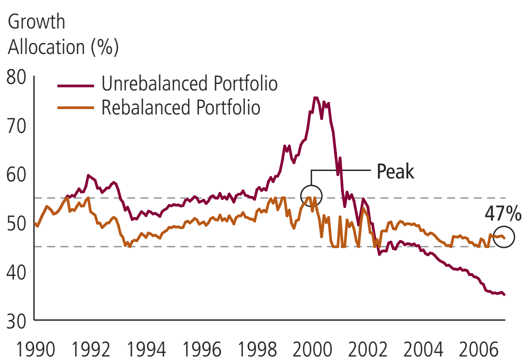
The Benefits of Rebalancing: Improved Results

Now let's imagine that the portfolio was rebalanced using our proprietary strategy. In contrast with the unrebalanced portfolio, the rebalanced portfolio had less exposure to the big growth cycle in the late 1990s, but it also had more exposure to value stocks when the cycle turned.

In the end, our rebalanced portfolio was less risky. It peaked at $624,000 instead of $680,000 and its subsequent low was slightly higher than the unrebalanced portfolio.

Disciplined Rebalancing Can Increase Returns and Reduce Risk

$100,000 Growth/Value Stock Portfolio (Initial Allocation 50/50)



Growth of $100,000
1990–2006

	Peak	Subsequent Low	Ending Value
Unrebalanced Portfolio	$680,000	$266,000	$519,000
Rebalanced Portfolio	$624,000	$292,000	$555,000

Past performance does not guarantee future results. For definition of methodology and indices see previous chart. There can be no assurance that rebalancing will achieve the intended results, and the costs of rebalancing may be significant over time. An investor cannot invest directly in an index. Please see back panel for index descriptions.

Source: Standard & Poor's and AllianceBernstein

Of course, it's not the peaks and valleys that matter but where you end up: the rebalanced portfolio's lower risk produced a higher ending value and was more balanced in its exposures to growth and value.

Following a disciplined rebalancing strategy can help investors control their emotions and their portfolios, and it may also enhance their risk/return balance.

If Rebalancing Is So Great, Why Isn't Everyone Doing It?

Rebalancing seems logical enough. Unfortunately, it also runs counter to our emotions. Investors may understand intellectually that rebalancing is good for the long-term health and safety of their portfolios, but they can't resist the urge to chase what's hot today. In that sense, rebalancing our portfolios is like following nutritional guidelines—we know a balanced diet is better for our long-term health but we still reach for junk food.

To see just how much of a problem is created by human nature, we simply need to follow the money. Mutual-fund flows show that investors have historically chased performance, pouring money into successful asset classes even when it's no longer prudent to do so. Logic may be on the side of rebalancing but there's a strong temptation to let the winners run.

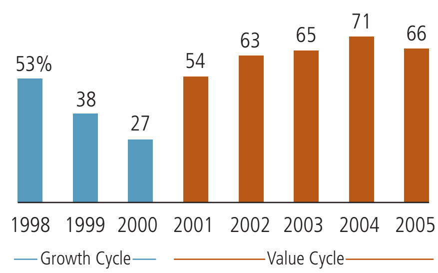
To Err Is Human: Why We Need Rules

In volatile markets, investors are frequently faced with an emotionally difficult choice. They can sell something that has done well to buy something that hasn't, or they can let their portfolios drift from their target. Faced with these two options, investors usually choose a third: sell the underperformer and buy more of the winner.

Take the late 1990s: in search of higher returns, investors poured billions into growth funds then did an about face into value.

Following Trends May Be Universal, But Runs Counter to the Principles of Rebalancing

Value Funds As Percent of Total U.S. New Sales



Current analysis does not guarantee future results.

As of December 31, 2005

Total U.S. new sales are represented by Lipper's Large-Cap Growth and Large-Cap Core Classifications.

Source: Investment Company Institute, Strategic Insight: SimFund, Lipper and Alliance Bernstein

Disciplined rebalancing requires investors to replace emotion with distinct rules. But which rules? How often should they rebalance? How far should they let portfolio allocations drift? And how closely to the original allocations should they return? Our research has answered these questions—addressing the mechanics of rebalancing and the emotional biases that cause investors to resist it.

Determining When to Rebalance

Investors can't be sure exactly when their portfolios will drift out of balance. Instead of rebalancing on an arbitrary date, investors are better off rebalancing when the market creates imbalances. Our research suggests that trigger points—allocation limits that define when a portfolio's structure has drifted too far—make more sense.

Weighing Costs and Benefits

The goal of rebalancing is to keep a portfolio true to its original risk/reward profile, but rebalancing isn't free, so it's important to weigh the benefits of rebalancing against its costs. When it comes to your portfolio, how far off course is too far?

The top chart in the display to the right shows the potential benefit of rebalancing—it grows slowly at first but intensifies as the portfolio drifts further from its original design. The costs of rebalancing (transaction fees and taxes) increase more steadily.

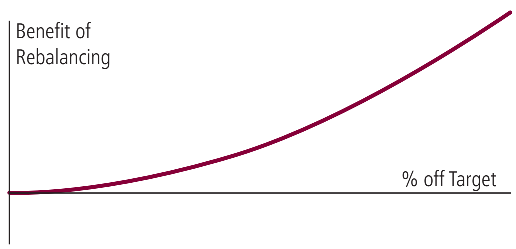
Rebalancing should occur when the benefits outweigh the costs rather than at defined calendar milestones.

Putting It Together

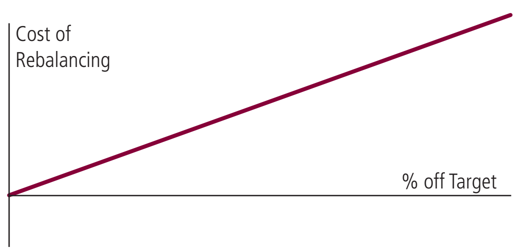
By combining the benefits and the costs, as shown in the last chart below, we can zero in on the optimal trigger point for rebalancing—the point at which the benefits exceed the costs. When the asset allocation is fairly close to its intended targets, the costs outweigh the benefits. As they drift further away, benefits take the upper hand.

Breaking Down the Rebalancing Equation

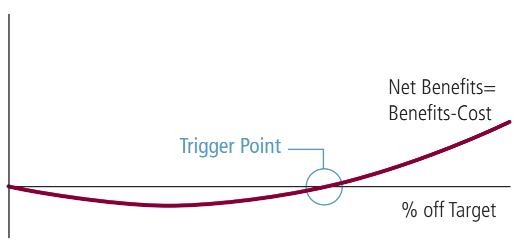
The further the portfolio strays, the greater the rebalancing benefit...



Add that calculation to the fees and taxes incurred...



And you get the trigger point at that place where the benefits exceed the costs.



Source: AllianceBernstein

It takes discipline to sell outperforming assets and buy underperforming ones. A rebalancing rule that is simple and justifiable makes this process easier.

Meet Me Halfway

Our rebalancing research has implications not only for determining when to rebalance, but also by how much. We've found that it's simply not cost-effective to return a portfolio all the way to its initial allocations.

Instead, our analysis has shown that the best way to minimize transaction costs while controlling portfolio risk is to return the "out of balance" asset class halfway back to its initial percentage. If an investor had a portfolio of 30% stocks and 70% taxable bonds, and its stock allocation drifted from 30% to 33%, it should be rebalanced to 31.5% of the portfolio. Returning the allocation any closer to its original target causes the costs to overwhelm the benefits.

Putting Rebalancing Into Practice

Every asset class has a unique set of benefits and costs when it comes to rebalancing—risks, trading costs, its relationship to other assets in the portfolio, and even the tax impact to the investor. This requires a unique trigger-point calculation for each asset class.

Specifically, our research has shown that asset pairs such as international and U.S. stocks, growth and value stocks, and municipal bonds and stocks should be rebalanced when they move 5% beyond their targeted allocations. Taxable bonds and stocks, on the other hand, should be rebalanced once they're off-target by 3%.

While you don't need a PhD in math to understand how rebalancing works, we've included a peek at the underlying equation for the analytically inclined.

How We Determine the Trigger Point

How Much Does It Cost to Trade?
The more an asset class costs to trade, the less frequently you should rebalance it, so asset classes with higher transaction costs typically have higher trigger points.

How Much Risk Do You Want?
Consider your investment objectives carefully when establishing your risk tolerance. A lower risk tolerance means a lower trigger point.

$$\text{Rebalancing Trigger Point} = \frac{2KC_i}{(\sigma_i^2 + \sigma_j^2 - 2\rho_{ij}\sigma_i\sigma_j)}$$

How Risky Is the Asset Class?
Riskier asset classes should have lower trigger points, because imbalances are potentially more risky.

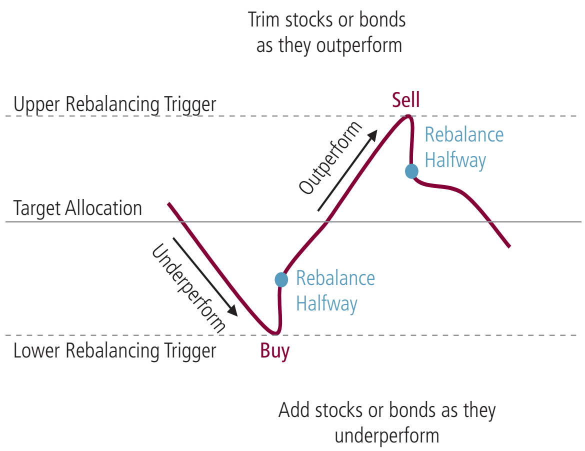
How Closely Do the Asset Class and Your Portfolio Track Each Other?
If the assets track more closely, you can allow a larger imbalance. If they don't, you'll probably want to keep the reins tighter.

How Risky Is the Rest of Your Portfolio?
Higher volatility in the rest of your portfolio should make you less tolerant of imbalances. The higher the volatility, the lower your trigger point should be.

The Big Picture

Our extensive research into rebalancing has led us to combine all of these rules into a rebalancing strategy that can be applied to every portfolio. Our rebalancing strategy reinforces the discipline of buying low and selling high. It does this by adding to underperforming assets as they reach the lower trigger point and trimming outperforming assets as they reach the upper trigger point.

Our Rebalancing Discipline Reinforces the Buy Low, Sell High Principle



Source: AllianceBernstein

Smoothing the Ride

It may seem reasonable to simply invest your money and leave things to the fate of the financial markets. But as sectors perform well, their weights in your portfolio will grow. As they weaken, their weights will fall. We wouldn't try to ride a horse without reins, and we shouldn't design a portfolio without a way to control it.

If you don't rebalance your portfolio, you may experience risk exposures that were never intended. On the other hand, following a disciplined approach to rebalancing your portfolio can enhance your long-term returns and provide a smoother ride along the way. Remember: building your portfolio is only half the battle—it's also important to maintain it.

Failing to rebalance your portfolio may take you on a ride you never anticipated.

AllianceBernstein is one of the largest and most established blend managers in the investment-management industry: We manage about $100 billion in blend assets for retail, institutional and high-net-worth clients, leveraging our strength in both growth and value investing.

Our blend strategies are an important part of a suite of diversified investment solutions that we've designed to help our clients build and preserve their wealth. We're particularly proud of having been highly ranked in a 2005 Greenwich Associates study that polled institutional clients and consultants—among the most discriminating stakeholders in the investment industry. Alliance's U.S. growth equity services ranked in the top 3%, and our international growth services were ranked in the top 15%. And we placed in the top 1% for both U.S. and international value.[1]

Our investment services come in a variety of platforms to suit individual needs, including:

- Mutual Funds
- Separately Managed Accounts
- Subadvisory Services
- Education Strategies
- Retirement Services

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[1] Source: Greenwich Associates Survey of U.S. Institutional Clients and Consultants, 2005. Percentile ranking is calculated using the Greenwich Quality Index, which measures the business performance of investment managers, as judged by institutional consultants. The 2005 peer group included 160 domestic equity investment managers, 195 international equity investment managers and 90 bond managers.

At AllianceBernstein, we realize that investors have choices for the management of their blend assets, and we value being the manager of choice for many trusted advisors. Speak to your financial professional today to learn more about how AllianceBernstein's Blend Strategies services can help you reach your goals.

Index descriptions: Both the S&P/Citigroup Primary Market Index (PMI) U.S. Growth and S&P/Citigroup PMI Pure Growth are unmanaged indices that track growth stocks among large-capitalization companies, which represent the upper 80% of available market capital for the United States. Both the S&P/Citigroup Primary Market Index (PMI) U.S. Value and S&P/Citigroup PMI Pure Value are unmanaged indices that track value stocks among large-capitalization companies, which represent the upper 80% of available market capital for the United States.

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