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Standard Life

# Mechanical Rebalancing

**Where your firm is running investment portfolios for your clients, part of your ongoing service may involve ensuring that the portfolio continues to meet your client's requirements as agreed. Whilst reviews may be undertaken as part of agreed review discussions with you, some firms may also look to have a form of rebalancing facility which can be used in between any agreed reviews and without having to obtain client consent each time.**

Where such a facility is being used it is important that appropriate procedures are put in place to ensure that you do not inadvertently stray into the activity of 'managing investments' which requires additional regulatory permissions.

If you obtain client consent, during the relationship, to the firms mechanical rebalancing of an investment portfolio policy, you can rebalance the portfolio back to the original split without obtaining the client's consent each time. This can only be done legitimately where:

- The funds and asset allocation remain unchanged from the original recommendation
- No further 'discretion' is used by the adviser.

To show that no discretion has been exercised, there would need to be a rigid process in place setting out clearly the rebalancing processes.

Features of a mechanical rebalancing process would include:

- Having the client's agreement to rebalancing in advance
- Rebalancing taking place on pre-agreed dates
- Rebalancing the portfolio back to an original agreed asset allocation
- No change of fund selection.

Any deviation from the above would constitute discretion and you would need to apply for discretionary permissions or seek the client's consent to rebalance.

## Considerations for mechanical rebalancing

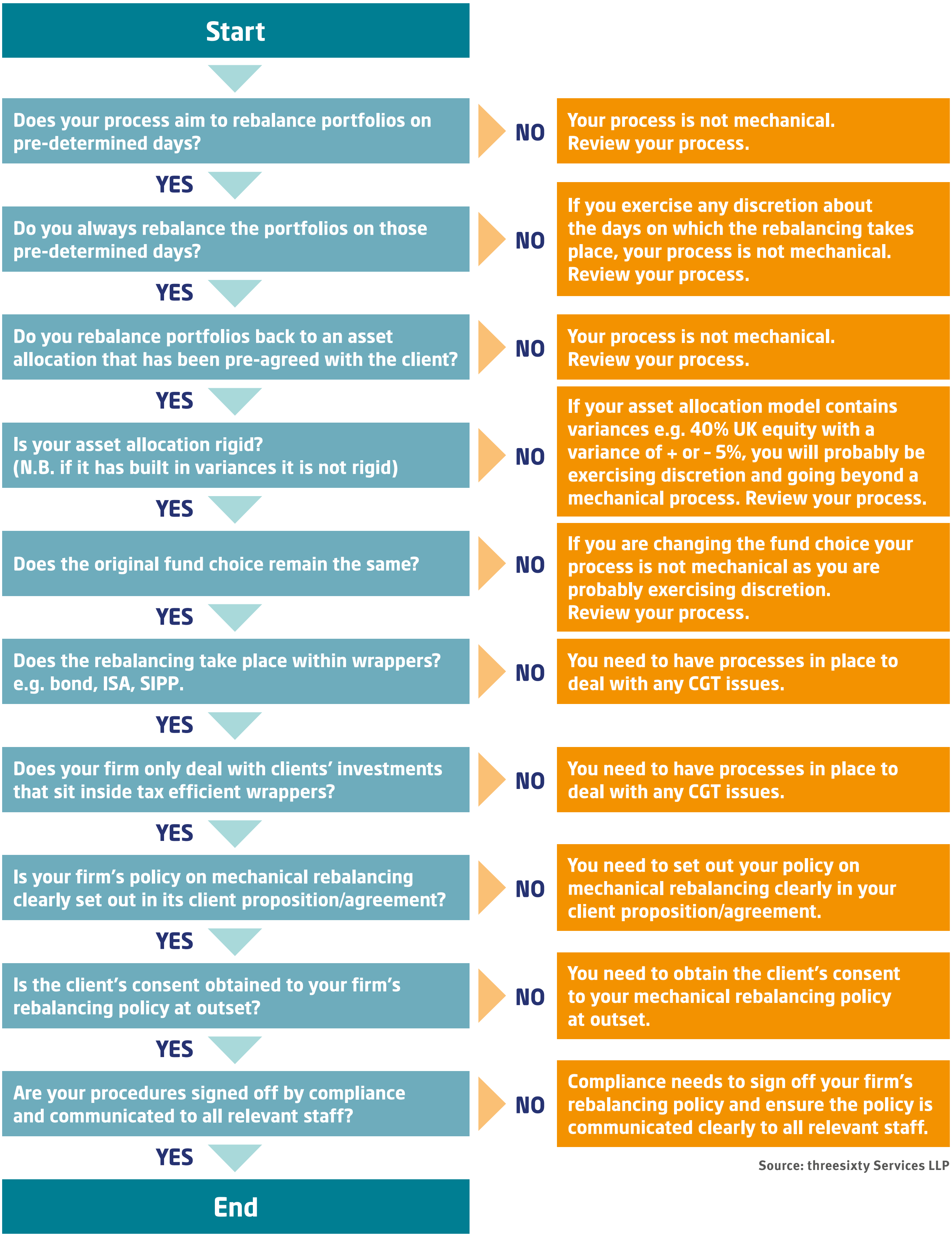
1. Your firm's overall investment proposition and philosophy. If your firm is charging clients for ongoing reviews and active management, does a mechanical rebalancing model suit this philosophy?
2. Your firm's service proposition and client agreement should explain clearly how the mechanical rebalancing works and the precise parameters.
3. The suitability report for each initial portfolio recommended should explain clearly the initial agreed asset allocation and how the portfolio will be rebalanced back to that agreed allocation.
4. The client's specific agreement to the mechanical rebalancing process should be obtained at the outset.
5. Your firm's compliance monitoring systems should check that mechanical rebalancing is taking place and that no element of discretion is being used. Review processes should ensure reviews are checking that any rebalancing is indeed 'mechanical'.

## The potential risks

- Rebalance must proceed at agreed times – even if this might not be appropriate e.g. due to market conditions
- Rebalance of funds must proceed as agreed – even if this means selling from good funds and buying into poor funds
- Potential charges or switching penalties for the client
- Potential CGT issues for the client. You should ensure that any gains arising from the rebalancing did not exceed any CGT allowances resulting in a tax liability. Care also needs to be taken to ensure that the client does not forget that all or part of their annual exemption may be used by the rebalancing process.

## Mechanical rebalancing considerations

The flow chart below highlights some of the considerations of mechanical rebalancing.



**Start**

| | | |
|---|---|---|
| Does your process aim to rebalance portfolios on pre-determined days? | NO | Your process is not mechanical. Review your process. |
| YES | | |
| Do you always rebalance the portfolios on those pre-determined days? | NO | If you exercise any discretion about the days on which the rebalancing takes place, your process is not mechanical. Review your process. |
| YES | | |
| Do you rebalance portfolios back to an asset allocation that has been pre-agreed with the client? | NO | Your process is not mechanical. Review your process. |
| YES | | |
| Is your asset allocation rigid?<br>(N.B. if it has built in variances it is not rigid) | NO | If your asset allocation model contains variances e.g. 40% UK equity with a variance of + or - 5%, you will probably be exercising discretion and going beyond a mechanical process. Review your process. |
| YES | | |
| Does the original fund choice remain the same? | NO | If you are changing the fund choice your process is not mechanical as you are probably exercising discretion. Review your process. |
| YES | | |
| Does the rebalancing take place within wrappers? e.g. bond, ISA, SIPP. | NO | You need to have processes in place to deal with any CGT issues. |
| YES | | |
| Does your firm only deal with clients' investments that sit inside tax efficient wrappers? | NO | You need to have processes in place to deal with any CGT issues. |
| YES | | |
| Is your firm's policy on mechanical rebalancing clearly set out in its client proposition/agreement? | NO | You need to set out your policy on mechanical rebalancing clearly in your client proposition/agreement. |
| YES | | |
| Is the client's consent obtained to your firm's rebalancing policy at outset? | NO | You need to obtain the client's consent to your mechanical rebalancing policy at outset. |
| YES | | |
| Are your procedures signed off by compliance and communicated to all relevant staff? | NO | Compliance needs to sign off your firm's rebalancing policy and ensure the policy is communicated clearly to all relevant staff. |
| YES | | |

**End**

Source: threesixty Services LLP

**Every client's circumstances will be different and require advice. Standard Life accepts no responsibility for advice that may be formulated on the basis of this information.**

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