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Research on Dynamic Portfolio Rebalancing Strategies with Explicit Consideration of Transaction Costs

Zhenghao Liang*

The Hang Seng University of Hong Kong, Hong Kong, China

**Corresponding author: Zhenghao Liang.*

Abstract

Classical portfolio theory frequently assumes frictionless markets, but in reality, transaction costs, like fees and market impact, can erode returns and cause excessive turnover. Incorporating these costs transforms rebalancing from a mechanical rule into a strategic decision: determining exactly when and how much to trade to restore desirable exposures efficiently. This study proposes a dynamic rebalancing framework that explicitly models proportional transaction costs within a multi-period optimization setting. By introducing a transaction cost function, portfolio adjustment becomes a rigorous optimization problem balancing expected returns, risk exposure, and total rebalancing costs. This cost-aware framework empowers investors to avoid unnecessary trading, preserving risk control while improving net performance. To solve this, specific algorithmic procedures are designed to enhance computational efficiency in realistic, multi-asset scenarios. Empirical evaluations using historical financial data compare this cost-aware strategy against conventional periodic and threshold-based methods. Performance is assessed across metrics including cumulative return, portfolio volatility, turnover rate, and net returns after costs. The empirical results demonstrate that explicitly integrating transaction costs into optimization significantly improves strategy performance. The proposed model successfully reduces unnecessary trading activity and lowers portfolio turnover while maintaining competitive risk-adjusted returns. Furthermore, sensitivity analyses reveal that transaction cost levels dictate the optimal rebalancing frequency and adjustment magnitude. Overall, this study provides a systematic modeling framework and strong empirical evidence for cost-aware dynamic portfolio rebalancing, offering practical insights for investors navigating complex environments.

Keywords

dynamic portfolio rebalancing, transaction costs, multi-period optimization, portfolio turnover, empirical backtesting

1. Introduction

Dynamic portfolio rebalancing addresses the continual drift of asset weights caused by market movements. While classical portfolio theory relies on optimal allocations under idealized, frictionless markets, real-world trading inevitably incurs transaction costs. Traditional rebalancing strategies that ignore these frictions often lead to excessive turnover and suboptimal net performance. Consequently, treating transaction costs as a core component rather than an afterthought is essential. This disconnect between frictionless theory and trading reality motivates the present study to focus on cost-aware optimization and practical decision rules for multi-period portfolio management. The inclusion of transaction costs in dynamic portfolio rebalancing is of considerable practical and theoretical importance. In real markets, trading frictions such as bid–ask spreads and brokerage fees erode returns and render frequent adjustments counterproductive. Acknowledging these frictions aligns model predictions with implementable strategies, preventing the exaggerated turnover produced by frictionless assumptions. Integrating explicit cost considerations reshapes the investor's trade-off between maintaining target allocations and preserving net performance, leading to more prudent rules. Trading costs can substantially reduce turnover while sustaining competitive risk-adjusted returns, highlighting the value of cost-aware algorithm design for practical portfolio management [1]. Key research questions include: How do different representations of transaction costs influence optimal rebalancing policies? Under what market conditions is it optimal to tolerate larger deviations from target weights rather than execute immediate corrections? How sensitive are the proposed strategies to model assumptions regarding return dynamics and cost levels? Finally, what empirical performance improvements can cost-aware rebalancing strategies deliver relative to conventional approaches evaluated on historical data? The research employs a blended methodological approach integrating theoretical modeling, numerical optimization, and empirical back testing. First, building on established portfolio theory, a multi-period decision problem is formulated where portfolio weights evolve stochastically and adjustments incur proportional costs. This formulation informs an optimization framework that balances expected return, risk control, and transaction costs. Second, to render the framework computationally tractable for realistic asset universes, algorithmic procedures combining convex optimization techniques with pragmatic heuristics for turnover control are developed and validated in a simulated environment. Third, the empirical component evaluates strategy performance on historical market data against benchmarks like periodic and threshold-based policies, measuring net returns after costs, volatility, and turnover. The overall approach is informed by recent work on dynamic mean–variance optimization with proportional transaction costs, which highlights the practical importance of explicitly incorporating trading frictions into rebalancing models to avoid excessive turnover and to achieve more realistic performance assessments [2]. This study systematically guides the reader from foundational concepts to empirical validation by first establishing the research context, objectives, and methodology (Chapter 1), and reviewing relevant literature on portfolio theory and cost-aware multi-period optimization [3] (Chapter 2). It then develops a computationally tractable, multi-period optimization framework that explicitly incorporates realistic transaction costs (Chapter 3), and concludes by empirically validating the proposed model using historical market data to demonstrate its robustness and practical advantages over conventional rebalancing strategies under various cost regimes [4].

2. Related Work and Theoretical Background

2.1 Foundations of Portfolio Theory

The foundations of portfolio theory rest on evaluating investment decisions via portfolios rather than isolated assets. Early advances emphasized risk-return trade-offs, where rational investors balance expected returns with variability. Diversification is the central mechanism for risk reduction; combining assets with imperfectly correlated returns achieves more favorable risk-return profiles. Subsequent developments introduced formal frameworks for choosing efficient portfolios, maximizing return for a given risk level or minimizing risk for a return objective. The theory distinguishes between undiversifiable systematic risks and mitigatable idiosyncratic risks. While classical models typically assume frictionless markets, they provide enduring principles: align allocations with investor preferences, exploit diversification, and recognize that optimal decisions require jointly considering return expectations and inter-asset relationships.

2.2 Dynamic Portfolio Rebalancing Strategies

Dynamic portfolio rebalancing strategies have evolved from simple periodic rules toward model-driven approaches explicitly weighing the trade-off between maintaining target allocations and adjustment costs. Early methods favored calendar-based rebalancing for operational simplicity, while tolerance-band techniques sought to reduce turnover by intervening only when weights drifted beyond preset limits. Recent research emphasizes dynamic decision rules incorporating asset return dynamics, volatility, and correlations to determine trade timing and magnitude. These approaches treat rebalancing as a control problem where expected benefits must justify immediate and future trading frictions. Algorithmic implementations utilize optimization to balance risk, return, and cost, allowing adaptation to changing market regimes. The literature also highlights that effective dynamic rebalancing requires robust estimation procedures and stress testing to ensure that model-driven signals remain reliable under different market scenarios and that operational constraints are respected [5].

2.3 Transaction Cost Modeling in Portfolio Optimization

Modeling transaction costs is fundamental to bridging theoretical optimization and practical implementation. While early discussions treated costs as negligible, recent research recognizes that explicit incorporation of trading frictions alters optimal allocations and rebalancing frequency. Leal, Ponce, and Puerto examine portfolio selection when transaction pricing interacts with decision-makers at two levels, demonstrating that endogenous cost structures can materially influence optimal trading policies; their analysis highlights that transaction costs are not merely exogenous penalties but can be shaped by market participants and pricing mechanisms, thereby affecting portfolio choice and turnover behavior [6]. Modern cost models distinguish between components like proportional fees, bid–ask spreads, and market impact. Effective modeling must balance descriptive accuracy with computational tractability to ensure scalable optimization, integrating economic microstructure insights with optimization constraints to reflect market realities.

2.4 Optimization Approaches for Portfolio Rebalancing Problems

Optimization methods for portfolio rebalancing encompass algorithmic techniques designed to adjust asset weights amidst competing objectives, seeking an optimal trade-off between return, risk, and trading costs. Deterministic approaches formulate rebalancing as constrained problems solved by quadratic or linear programming, benefiting from clear convergence properties. Stochastic and dynamic programming techniques extend this by explicitly modeling return uncertainty and sequential decision-making, capturing the temporal dimension of market evolution. Heuristic algorithms provide flexible alternatives for complex, nonlinear cost functions. More recently, machine learning methods have been applied to learn rebalancing policies from data, adapting to changing environments. Crucially, any effective optimization method must integrate realistic transaction cost models, computational efficiency, and robustness checks to deliver implementable rebalancing rules that perform well out-of-sample.

2.5 Research Gaps and Motivation

Existing studies have advanced the understanding of portfolio adjustment under realistic trading conditions, yet significant gaps remain. Zhou and Li investigate portfolio adjustment models that incorporate transaction costs, emphasizing the role of semi-entropy measures in capturing downside risk and demonstrating that explicit cost modeling materially alters optimal trading decisions [7]. Building on this insight, the literature still lacks a unified framework integrating multi-period dynamics, practical cost structures, and computationally efficient rules for large asset universes. Existing empirical studies leave three significant gaps: (1) reliance on stylized cost assumptions that limit applicability in volatile markets, (2) unresolved implementation challenges regarding numerical tractability, and (3) underexplored robust out-of-sample performance. These gaps necessitate a comprehensive, cost-aware dynamic rebalancing framework that explicitly models proportional transaction costs across multiple periods and is validated through empirical experiments to assess robustness.

3. Cost-Aware Dynamic Portfolio Optimization Framework

3.1 Problem Formulation of Multi-Period Portfolio Rebalancing

In dynamic portfolio rebalancing, the problem formulation begins by characterizing how asset weights evolve and how trading interventions can restore desired allocations while accounting for market frictions. Jin and Ou analyze optimal portfolio selection in a discrete-time setting with transaction costs, emphasizing that incorporating trading frictions fundamentally alters the timing and size of optimal trades; their work demonstrates that failure to model costs leads to excessive trading and suboptimal long-term performance, which motivates a formulation that explicitly balances expected return against incurred costs [8]. Complementing this perspective, Zhang investigates portfolio selection under different convex transaction cost structures and highlights that the specific shape of the cost function, whether proportional, fixed, or convex, affects both the decision thresholds for rebalancing and the resulting trade quantities, implying that a flexible problem statement must allow for various cost specifications to capture practical trading environments [9]. The present formulation maximizes net benefit from rebalancing decisions over a planning horizon, subject to stochastic asset price evolution and constraints imposed by transaction costs and risk limits.

3.2 Transaction Cost Modeling and No-Trade Effects

Recognizing the pivotal role of transaction costs, this section integrates a pragmatic cost perspective into the dynamic portfolio decision process. Transaction costs are treated as endogenous determinants of trading frequency and trade size: when costs are high, larger deviations from targets are tolerated to avoid trading, whereas low-cost environments justify finer adjustments. The model balances expected portfolio performance against cumulative execution burden, viewing trading as a trade-off between the marginal benefit of reducing allocation drift and the marginal cost of transactions. This framework produces endogenous no-trade regions and adaptive thresholds varying with market volatility, liquidity, and risk preferences, reducing unnecessary turnover. This perspective follows empirical and theoretical insights that proportional transaction costs materially alter optimal trading policies and must be incorporated into any realistic discrete-time rebalancing model [10].

3.3 Optimization Formulation of Cost-Aware Rebalancing

This section develops a practical optimization framework reconciling portfolio objectives with trading cost realities. The framework treats rebalancing as an economic trade-off: adjustments must deliver sufficient marginal improvement in expected risk-adjusted return to justify incurred transaction costs. It integrates three components, return forecasts, risk assessment, and a cost penalization mechanism, into a single decision rule. Return forecasts establish directional incentives, risk assessment quantifies how deviations affect volatility, and cost penalization assigns a realistic price to turnover, discouraging inconsequential adjustments. Candidate trades are evaluated by estimating the net benefit of proposed allocations, subtracting estimated trading costs, and adjusting for risk changes. Rebalancing triggers only when net benefits exceed predefined thresholds. Computationally efficient heuristics and constraints like minimum trade sizes maintain implementability, producing a disciplined, cost-aware rebalancing policy.

3.4 Algorithm Design and Computational Procedure

The algorithmic design for the proposed framework emphasizes practicality, computational efficiency, and robustness to market noise. The pipeline includes state estimation, decision rule evaluation, trade sizing, and execution simulation. First, state estimation procedures update asset return and covariance estimates using rolling-window techniques to capture evolving market dynamics. Next, the decision rule evaluation assesses whether current deviations justify intervention by comparing expected risk-return improvement against marginal transaction costs. When warranted, the trade-sizing module computes adjusted target weights achieving a cost-efficient compromise between ideal allocation and turnover minimization, utilizing simple heuristics to avoid micro-trades. Iterative numerical methods and convex approximations ensure rapid convergence in moderate-dimensional asset universes. An execution simulation layer models slippage to provide realistic cost estimates. The resulting algorithm achieves a pragmatic balance: excessive turnover is reduced and net performance is improved while remaining implementable in a live trading environment, consistent with practical concerns about transaction cost management highlighted in prior work [11].

3.5 Data Description and Experimental Design

The empirical study draws upon historical market data to create a realistic testing environment. Primary data include daily closing prices, volumes, and spreads for a diversified set of liquid equities over a multi-year horizon, used to approximate observable transaction cost components. Standard commission schedules and slippage estimates reflecting institutional-sized trades are incorporated. The experimental universe is partitioned into training periods for calibrating risk models and evaluation periods for out-of-sample performance assessment. Baseline policies, periodic rebalancing, threshold-based band rebalancing, and a frictionless-optimal benchmark, are implemented for comparison. Evaluation employs metrics capturing gross and net outcomes after costs, including cumulative return, annualized volatility, Sharpe ratio, and turnover. Optimization routines are tuned with realistic constraints on trade sizes and execution latency. The experimental design follows best practices in empirical asset management research to provide credible evidence on how explicit modeling of transaction costs influences dynamic rebalancing decisions and portfolio outcomes, consistent with the approach and insights discussed in the literature on nonlinear transaction costs and constrained optimization in portfolio construction [12].

4. Empirical Analysis and Discussion

4.1 Experimental Design

The empirical experiments are designed to evaluate the practical effectiveness of the proposed cost-aware dynamic rebalancing framework across realistic market scenarios and compare performance against conventional rules. Representative historical asset return series are selected, and the sample is divided into training and testing intervals to ensure strict separation of calibration and out-of-sample evaluation. Following the approach of Seunghyun and Yourim, who investigated adaptive strategies for online portfolio selection under transaction costs and emphasized realistic cost modeling and turnover control, proportional transaction costs are incorporated and portfolio turnover is tracked to quantify trading burden [13]. In line with the multi-period perspective emphasized by Zhou and Li, who explored multi-period portfolio management with transaction costs and constraints on downside risk, performance is evaluated over multiple rebalancing horizons and stress periods [14]. The study compares the proposed rule against fixed-interval and threshold-triggered strategies, reporting cumulative returns, volatility, turnover, and net returns.

4.2 Performance Comparison of Rebalancing Strategies

In assessing rebalancing strategies, a comprehensive comparison emphasizing gross and net outcomes is conducted. The evaluation examines cumulative returns, volatility, drawdowns, turnover, and net performance after transaction costs, detailing how cost-aware policies alter trading frequency and allocation drift. Back tests across multiple market regimes benchmark strategies against conventional periodic and threshold-based rules. It is observed that cost-aware strategies result in significantly lower trading frequencies and larger average adjustment sizes. This disciplined trading leads to lower turnover and reduced realized transaction expenses, enhancing net returns even when gross returns are similar across methods. Risk-adjusted metrics show cost-aware rebalancing maintains comparable volatility and drawdown profiles to traditional approaches, indicating reduced trading does not materially increase exposure to adverse market moves. These findings align with empirical evidence suggesting that incorporating transaction cost considerations into the rebalancing decision framework improves practical performance [15].

4.3 Impact of Transaction Costs on Rebalancing Behavior

This subsection examines how transaction costs alter the tradeoff between maintaining target allocations and preserving net investment performance. Kimball et al. argue that rebalancing decisions cannot be evaluated solely by pre-cost returns because trading frictions change marginal trade benefits; a band of inaction around the target allocation emerges where refraining from trading is optimal until deviations justify costs [16]. The empirical impact analysis documents how varying proportional transaction costs affect turnover and risk-adjusted performance. At low-cost levels, frequent small adjustments remain beneficial. As costs rise, the model shifts toward less frequent, larger corrections, reducing turnover but increasing drift. It is found that transaction costs disproportionately penalize high-frequency micro-adjustment strategies, and optimal rebalancing thresholds expand nonlinearly with cost magnitude. These results underscore the importance of explicitly modeling transaction costs in rebalancing rules [17].

4.4 Robustness and Sensitivity Analysis

In the robustness and sensitivity analysis, performance of the proposed cost-aware strategy under various plausible market conditions and parameterizations is examined, focusing on stability of net returns after costs, turnover, and downside risk. Stress tests varying transaction cost levels, asset return volatilities, and correlation structures are conducted to evaluate whether strategy advantages persist under market shifts. Sensitivity studies demonstrate dependence of optimal rebalancing thresholds on key inputs; higher proportional costs induce wider tolerance bands before corrective trades, reducing turnover but increasing drift. Evaluation is also performed on robustness to estimation errors by simulating scenarios with perturbed expected returns and covariance estimates, verifying whether cost-aware rules remain preferable under noisy signals. Out-of-sample back tests across multiple regimes confirm that improvements are not sample-driven. Results show that the framework maintains meaningful reductions in turnover and more stable after-cost performance across most perturbations, supporting robustness of cost-aware rebalancing rules [18].

5. Conclusions

This study has shown that integrating transaction costs into dynamic portfolio rebalancing frameworks materially alters optimal adjustment policies and delivers more realistic assessments of strategy performance. Multi-period investment behavior can produce substantially different trading patterns when transaction costs are present, highlighting the need to model costs jointly with temporal considerations to avoid excessive turnover and deterioration of net returns. Furthermore, incorporating transaction costs into computational models improves the implementation of rebalancing strategies for assets with complex dynamics, yielding more stable portfolios and reduced trading frictions in practice. Looking forward, extending the model to accommodate nonlinear and state-dependent transaction cost structures—including market impact scaling with trade size—would enhance realism. Incorporating investor-specific objectives beyond mean–variance preferences, such as tail-risk aversion, could produce personalized rules aligned with real-world mandates. Hybrid approaches combining model-based optimization with machine learning could exploit complex return dynamics while preserving interpretability. Finally, addressing practical deployment issues like execution latency and examining diverse asset classes would clarify interactions between transaction costs and market microstructure.

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Conflicts of Interest

The authors declare no conflict of interest.

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