

Rebalancing to Keep Your Portfolio on Track

Over time some asset classes or investments inevitably outperform or underperform others causing your portfolio allocation to shift. This is especially true during times of heightened volatility, like the markets are experiencing today. This shift, also known as “portfolio drift,” can significantly increase a portfolio’s risk and cause it to become misaligned with its target allocation. To address this problem, you will need to periodically rebalance your portfolio, or adjust the investment mix so that it reflects your target allocation or risk profile.

Many investors dislike rebalancing because it means selling winners in favor of losers. In addition, rebalancing can also generate transaction fees, as well as taxes on gains created by selling securities. Nonetheless, most financial professionals believe the advantages of rebalancing outweigh the disadvantages.

Correcting for Portfolio Drift

To appreciate how performance differences can affect a portfolio over time, throwing it out of sync with its original allocations, consider what happened to a hypothetical portfolio left unbalanced for the 20 years ended December 31, 2010. An original 70% allocation to U.S. stocks would have grown to 81%, while the other allocations would have shrunk, reducing their intended risk reduction role in the portfolio. As always, past performance is no guarantee of future results.¹

Bonds haven’t been as volatile as stocks over long periods of time, but recent history shows that they too can experience performance patterns that may alter asset allocation over time. Consider the divergence of

the stock and bond markets in 2008 and how that affected asset allocations. While the S&P 500 lost 37% during this period, long-term U.S. government bonds gained 23%. A portfolio composed of 50% of each at the start of the year would have shifted to an allocation of 34% stocks and 66% bonds at year’s end.¹

Take a Holistic View

If you have multiple investment accounts, determining whether to rebalance may involve several steps, beginning with a check of your overall allocation. This entails figuring how your money is divided among asset classes in each account and then across all accounts, whether in taxable brokerage, mutual fund or tax-deferred accounts.

To gain a full appreciation of your investment strategy, go beyond stocks and bonds and calculate the percentages you have in other asset classes, such as cash and real estate. In addition, you may want to evaluate your allocations to categories within an asset class. In equities, for example, you might consider the percentages in foreign and domestic stocks. For the fixed-income portion of your portfolio, you might break your allocation into U.S. Treasuries, municipals and corporate bonds. If you’re pursuing income from bonds, you may want to know the split among short, medium and long maturities.

How often should you rebalance? The usual answer is anytime your goals change; otherwise, at least once a year. However, to keep close tabs on your investment plan and make sure it doesn’t drift far from your objectives, you may prefer to set a percentage limit of variance, say 5% on either side of your intended target, which would trigger a review and possible rebalancing.

Cost-Effective Rebalancing Strategies

Consider these possibilities for reducing transaction costs and taxable gains when rebalancing:

- Make as many changes as possible in an account that charges low trading fees—for example, a low-cost brokerage account or a 401(k) account, which may offer free transactions.
- To avoid tax liability, rebalance using new money instead of moving existing money around. Or limit your immediate tax liability by making changes when possible in a tax-deferred account like a 401(k) or an IRA.
- If you're looking for new money to help rebalance your portfolio, consider using lump-sum payments such as a bonus or tax refund.

¹Source: Standard & Poor's. Performance is for the periods indicated. Stocks are represented by the S&P 500, bonds by long-term U.S Government bonds. Investors cannot invest directly in any index. Past performance does not guarantee future results.

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