THE IMPORTANCE OF REBALANCING

Overview: Rebalancing may be one of the most basic principles of prudent investing, but it can also be one of the most difficult to practice as well.

Rebalancing can be difficult for many investors. Often times, investors are required to sell assets that are outperforming the market to buy ones that are underperforming. This can be a difficult task, but one that is necessary to help investors keep on track to achieve their goals while taking an appropriate level of risk.

BASICS

The process behind rebalancing is simple. When investors create their investment plan, they settle on target allocations to specific asset classes. These allocations provide investors with an expected return commensurate with their risk tolerance and likelihood of achieving their financial goals. As some asset classes outperform while others underperform, the actual allocations stray from their targets. Rebalancing is the act of restoring the portfolio to those target allocations.

Rebalancing does not always mean selling one asset class to buy another. Sometimes investors can use new available cash to purchase underperforming asset classes to help restore target allocations.

STRATEGIES

While rebalancing helps increase investors' chances of reaching their financial goals, there are a few things to consider to make rebalancing as efficient as possible. One is transaction costs. Unless using cash, selling one asset class to buy another involves incurring transaction costs on both ends. Whenever possible, investors should look to use new cash to help restore their asset allocation to desired levels.

Investors should also consider minimizing the impact of short-term gains that may be realized by waiting until either long-term gains can be realized or until new cash becomes available. Investors can also use accumulated losses to offset these gains.

Rebalancing doesn't have to involve getting back to a specific target allocation. For many investors, having an allocation range is the most efficient way to keep their portfolios balanced. For example, an investor may have a target allocation of 10 percent to a specific asset class, but have a range of 8–12 percent. This helps keep the portfolio on track while minimizing the size of the transaction costs involved with rebalancing to the proper allocation.

MYTHS

There are a few misconceptions regarding rebalancing. One is that rebalancing is a "reversion to the mean" strategy. Investors who use a reversion to the mean strategy would sell outperforming investments to buy underperforming investments. This is not quite what is meant by rebalancing. Consider the following example.

An investor has a target allocation of 50 percent equities and 50 percent fixed income. The equity portion has an expected return of 10 percent, and the fixed income portion has an expected return of 6 percent. In the first year of following this plan, equities return 9 percent, while bonds return 7 percent.

A reversion to the mean strategy would involve selling bonds (as they produced above average returns) to buy stocks (as they produced below average returns). On the other hand, rebalancing aims to restore investors to their original allocations. In this case, reversion to the mean would not accomplish the rebalancing goals, and in fact would take the investor further away from his original allocation.

BUCKINGHAM STRATEGIC WEALTH

Another myth about rebalancing is that it increases expected returns. In many cases, rebalancing will require investors to sell a higher expected returning asset class to purchase more of a lower expected returning asset class. For example, most of the time, investors would be expected to:

- Sell value stocks to buy growth stocks
- Sell small-cap stocks to buy large-cap stocks
- Sell emerging-market stocks to buy developed-market stocks

Rebalancing in this manner actually lowers the expected return of the portfolio (while lowering the risk profile as well). Of course, this will not always be true. For example, when bonds outperform stocks, rebalancing will increase the expected return of the portfolio by selling the lower expected returning asset class to purchase the higher expected returning asset class. However, it is important to remember that rebalancing a portfolio helps maintain the asset allocation required to achieve the balance between the risk and reward required for a specific investor.

SUMMARY

Rebalancing not only ensures the portfolio stays aggressive enough to meet needs when stock prices fall, it also prevents the portfolio from getting too risky when the equity market is outperforming. Left unbalanced, a portfolio becomes concentrated in higher-return assets, changing from the risk and return profile originally intended.