

After the Rebound: It's Time to Review—and Rebalance—Your Portfolio

Given the remarkable turnaround in the stock market in the latter months of 2009, the annual ritual of reviewing and rebalancing portfolio assets has taken on new significance for the individual investor.

What Is Rebalancing?

It is important to understand that your investment mix (known as your asset allocation) is always subject to change. That's because investment performance could cause the value of some assets to rise (or fall) more than others. When an asset allocation changes in this way, investment professionals often say it has "drifted" or become unbalanced. In that event, you may need to rebalance your asset allocation so that it again has the risk and return potential you desire.

One way to rebalance involves selling investments in the asset class that currently exceeds your allocation target. Another is to buy investments in the underperforming asset class or to use new money to increase the underweighted assets. Or you may opt for a combination of those strategies.

Many investors dislike rebalancing because it means selling winners in favor of losers. Rebalancing can also generate transaction fees, as well as taxes on gains created by selling securities. (See the Money-Saving Tips below.) Nonetheless, most financial professionals believe the advantages of rebalancing outweigh the disadvantages.

Allocation Drift: An Example

To appreciate how performance differences can affect an unbalanced portfolio over time, consider

what happened to a hypothetical portfolio consisting of 70% domestic equities, 10% foreign equities, 10% U.S. government bonds and 10% cash instruments. Left unbalanced for the 20-year period ending December 31, 2008, the original 70% allocation to U.S. equities had grown to 76%, while the other allocations shrank, reducing their intended risk reduction role in the portfolio. As always, past performance is no guarantee of future results.¹

Consider the Big Picture

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 versus domestic stocks. For the fixed-income portion of your portfolio, you might divide 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 any time 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, that would trigger a review and possible rebalancing.

Money-Saving Tips

When rebalancing, consider the following tips for potentially reducing transaction costs and taxable gains:

- Make as many changes as possible in an account that charges low trading fees—for example, a 401(k) account, which may offer free transactions, or a low-cost brokerage account.
- 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 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. Domestic stocks are represented by the total returns of Standard & Poor's Composite Index of 500 stocks, an unmanaged index that is generally considered representative of the U.S. stock market. Government bonds are represented by the total returns of the Barclays Long-Term Government Bond Index. Money markets are represented by the total returns of the Barclays 3-Month Treasury Bills index. Foreign equity is represented by the total returns of the Morgan Stanley Capital International Europe, Australasia, Far East (EAFE®) index. Note that prior to November 2008, the Barclays indexes were compiled by Lehman Brothers. Past performance is not a guarantee of future results.

Stock investing involves risk including loss of principal.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

International and emerging market investing involves special risks such as currency fluctuation and political instability and may not be suitable for all investors.

Asset Allocation does not ensure a profit or protect against a loss.

Municipal Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Federally tax-free but other state and local taxes may apply.

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