Rebalancing

INVESTMENT STRATEGY

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All investors have a level of risk they are willing to tolerate to try to earn a corresponding projected return. Once their risk profile has been determined and an investment strategy has been implemented, it is important to adhere to that level of risk in managing the portfolio. To accomplish this, it is necessary to continually monitor and ensure that each asset class stays near its target. When asset classes deviate from their targets, rebalancing is needed to bring the portfolio back in line.

Rebalancing is the disciplined process of selling from the best performing asset classes while buying into asset classes that have not performed as well. Over time, asset classes such as stocks and bonds will deviate from their target weightings as each move up or down. For example, if a portfolio isn't rebalanced during a long market upswing, it will likely have a much higher percentage in stocks and be exposed to a lot more risk than the investor originally intended. Disciplined rebalancing allows investors to use market gyrations to their advantage to enhance a portfolio's return while controlling investment risk. This objective process forces investors to "buy low and sell high," which is a time tested adage for investment success.

Benefits of Rebalancing

- **Rebalancing brings peace of mind**—without rebalancing, portfolios will deviate from their asset class targets over time. During a bull market in stocks, exposure to that asset class can greatly increase leaving investors with a lot more risk than they anticipated. Rebalancing avoids this problem by helping investors to adhere to a selected level of risk over the long term.
- **Rebalancing can enhance returns**—in a diversified portfolio containing multiple asset classes, some of those asset classes may move dramatically in a short period of time. Rebalancing capitalizes on this volatility by selling assets that have gone up in value while buying those that are currently out of favor. In other words, rebalancing helps you to systematically "buy low and sell high."
- **Rebalancing creates discipline**—selling your "winners" and adding to your "losers" can sometimes be easier said than done. Research has shown that people who make investment decisions emotionally tend to underperform over the long run. Instead of trying to predict the future, systematic rebalancing takes the emotion out of the equation and applies discipline to investing.

As part of the rebalancing process, other factors need to be considered, such as the cost of trading, the realization of capital gains in taxable accounts, and the effect of the wash sale rule on income tax. The wash sale rule prohibits claiming a loss on the sale of securities if virtually equivalent assets are purchased within 30 days. Before making a trade, it's critical to consider all tax ramifications and trading costs. Due to these factors, rebalancing too often can be a drag on performance over the long run. Therefore, a disciplined approach is needed to reap the benefits of rebalancing.

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