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The Art of Rebalancing

By Lauryn Agnew *January 2009*

A clear rebalancing policy will keep emotions out of the decision-making process.

When markets have big shifts, as we've seen in 2008, portfolios can get out of line with your investment policy. Let's look at a simple example: a $ 1 million portfolio at the beginning of this year starts with an asset allocation of 60% stocks and 40% bonds, and if no changes had been made all year, the equity portion would be off about 40% year-todate, and the bond portfolio might be up slightly, maybe 5%. The resulting asset allocation on the now $780,000 portfolio would be 46% stocks and 54% bonds. What do you do?

If your risk tolerance, long-term objectives, and time horizon haven't changed, then you have the opportunity to rebalance back to your target of 60% stocks/40% bonds. Returning to the strategic allocation gives you the best chance to recover the losses by "*selling high*" some of the bond portfolio, and "*buying low*" at the bargain prices in the equity markets. You have ensured that you will have the opportunity to participate in the recovery of the equity market.

Rebalancing can be emotionally difficult; when things look particularly bad for the markets, the economy and the consumer, it is very difficult to buy into risky asset classes that just burned you. But the biggest risk in investing is being out of the market and not being positioned to participate in the recoveries. Recoveries from bear markets tend to take place in spurts and to be concentrated in a few good days, which you don't want to miss. A good investment policy provides the discipline to rebalance regularly, keeping emotions out of the decision-making process.

One final thought; before you pull the trigger to rebalance, check the liquidity in the markets. In this last quarter, we've seen liquidity affected so dramatically that liquidations of certain parts of portfolios (e.g., municipal and investment grade taxable bonds in the fourth quarter and later in private equity) have been difficult or even impossible, preventing the investor from restoring the target asset allocation quickly. The rebalancing transactions could cost you more than the benefit you receive from the rebalancing. So if you can't get good prices for the securities you're selling, rebalance in steps and give the markets a little more time to process the trades. It's the prudent thing to do.