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The fine art of rebalancing your portfolio

Your asset allocation decision establishes the percentages of your portfolio dedicated to various asset classes—stocks, bonds, cash and, perhaps, other less traditional investment vehicles. That decision establishes the risk/reward benchmark for your portfolio.

Over time, your portfolio's composition is apt to shift because the relative performance of the asset classes differs as the markets move. If stocks outperform other asset classes, for example, they soon will overweight the portfolio. The effect is more pronounced in volatile markets. Welcome though that great stock performance may be, the relative riskiness of the portfolio increases as well. What's more, changing life circumstances may affect your time horizon or tolerance for risk.

As a result, some rethinking, and some adjustments, may be necessary. Portfolio rebalancing can provide smoother sailing for your portfolio.

The rebalancing process

Rebalancing requires selling investments that have done well and investing more heavily in those that have underperformed. If you find the concept of rebalancing a bit unsettling, you're not alone. It's a task that asks you to go against market conditions. But it helps you to resist the temptation to jump into investments at the top of the market and to sell them when the market reaches bottom. Instead, rebalancing pushes you to buy low and sell high.

Market forces will continue to shape a portfolio, regardless of whether an investor is active or passive in management. In other words, if you do nothing, the market will do the rebalancing for you. The question is not whether your portfolio should be examined with an eye toward rebalancing, but who should do it: the market or, as a team, you and your investment advisor?

What can rebalancing your portfolio accomplish?

Generally, there are five benefits that result from rebalancing your portfolio. Rebalancing:

- Allows an investor to hold to his or her specific investment target.
- Takes into account an investor's change in goals or circumstances.
- Minimizes unnecessary or unintended risk.
- Helps investors resist the temptation to make ad hoc decisions.
- Permits an investor to implement his or her own rebalancing strategy, rather than letting the markets do so.

Strategies for taxable and tax-deferred accounts

Tax-deferred accounts are easier to rebalance because assets can be shifted, without tax consequences, to restore the target allocation. However, transaction costs are incurred, and if rebalancing happens too frequently, these expenses can have a negative impact on performance.

With taxable investments the concerns are about taxes as well as transaction costs. Therefore, it makes sense to rebalance taxable accounts using new funds that can be invested in the underweighted categories. Of course,

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paying a capital gain tax might be worth it if you can (1) lock in your gains by selling top performers and (2) minimize the impact of the sale by taking a long-term rather than a short-term gain. A word of caution: Returns can take a hit when transaction costs also are factored in, so investors should tread carefully as they undertake balancing their taxable investments. For this reason, taxable investments shouldn't be rebalanced as frequently or as aggressively as tax-deferred investments.

A few final words

Professionals agree that a thorough review, not impulsive decision-making, is an essential ingredient in order to achieve investment success. There are a number of different approaches to help you determine if you are reasonably on track or not. No matter which you choose, it's wise to consult with your investment advisor before beginning the rebalancing process. Finally, no matter when you rebalance, it's important to make it a routine activity. Failing to do so can result in disappointing investment results and significantly increased portfolio risk.

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Any developments occurring after January 15, 2007, are not reflected in this article.