4 Things to Consider When Rebalancing a Portfolio

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When you first set up an investment, you carefully created allocation ratios that fit the investor's needs and chose an asset mix to match. Over time, however, those allocations can stray from their original benchmarks, potentially leaving the portfolio too heavy in one asset class and underweight in others.

This imbalance can occur due to a variety of reasons. An imbalance can be created when the weight of an asset class shifts as assets rise and fall in value due to performance. Also, even the most experienced and savvy investors may make emotional or irrational decisions when choosing which assets to include in the portfolio, skewing it away from its original allocations. In some cases, imbalance is caused by income reinvestment, as investors reinvest back into high-performing assets and put too much weight in one asset class. Finally, a portfolio may become imbalanced as the result of selling off assets for the purpose of harvesting losses.

If a portfolio has shifted away from its initial asset benchmarks, it may be time to analyze whether a rebalance is required. There are three common approaches to rebalancing: redirecting money to lagging asset classes, adding new investments to lagging asset classes, or selling off a portion of holdings within outperforming asset classes (or some combination of the three).[1] Which approach to choose is dependent upon the individual investor's goals. No matter which method is used, rebalancing brings a host of potential benefits, ***including:***

- **Rebalancing renews discipline.[2]** Investing is a marathon – not a sprint. And like marathon training, investing is a practice with a long-term outlook, requiring discipline, strategy and focus. Many individuals lose sight of their discipline as their investing practice grows mundane or feels tedious. Rebalancing reminds investors of the original boundaries and why you established them in the first place.
- **Rebalancing removes unnecessary risk.[3]** One risk of the long-running bull market that we've experienced over the last several years is that investors may be too heavily weighted in stocks, creating a portfolio that exceeds their risk tolerance. Rebalancing identifies potential areas of risk before they become a problem.
- **Rebalancing can create additional return potential.** On the flip side of reducing unnecessary risk, rebalancing may also help investors identify opportunities to improve returns within the portfolio. This is especially true as markets shift and different asset classes become overperformers.

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Before shifting assets around to realign with initial allocation benchmarks, however, it's important to consider how rebalancing might impact an investor. Here are four things to think about before rebalancing:

1. **There are costs associated with rebalancing.** Account shifting could result in potential sales charges and other fees. Can the investor absorb these costs at this time? If not, rebalancing may need to wait.
2. **Rebalancing may produce capital gains in a taxable account.[4]** An investor may see an increase in their tax bill if capital gains result from selling off assets as part of a rebalance. However, this could be offset by harvesting losses from underperforming assets in the portfolio.
3. **Should the allocation benchmarks be changed?** Portfolio allocations should change as people do. Many investors don't consider that their risk tolerance decreases as their age increases – and never act to reduce risk as they near retirement. A Retirement Savings Risk Study conducted by MassMutual showed that a large percentage of survey respondents continued to invest aggressively even as retirement neared. Respondents indicated that they only backed off on their aggressive investing after a financial advisor recommended shifting to a more conservative approach.[5]
4. **Rebalancing shouldn't just happen by the calendar**. Many advisors review portfolios for potential rebalancing around the first of the year, especially after assets have been sold to harvest losses for tax purposes. And scheduling a regular time to review the portfolio is a best practice. However, you shouldn't rebalance just because the calendar says it's time to do so. Instead, consider rebalancing any time allocations have strayed a predetermined amount from their original limit. One example: Consider rebalancing any time allocations have strayed more than 5% outside their original boundaries.[6]

[1] Finra.org. "Rebalancing Your Portfolio." http://www.finra.org/investors/rebalancing-your-portfolio Accessed Nov. 5, 2018.
[2] Terry Savage. Baltimore Sun. May 17, 2017. "Rebalancing portfolio takes discipline." https://www.baltimoresun.com/business/success/terrysavage/tca-rebalancing-portfolio-takes-discipline-20170517-story.html Accessed Nov. 13, 2018.
[3] Tom Petruno. Kiplinger. Oct. 3, 2018. "How to Rebalance Your Portfolio." https://www.kiplinger.com/article/investing/T023-C000-S002-rebalancing-your-portfolio-to-reduce-risk.html Accessed Nov. 13, 2018.
[4] Barbara Friedberg. U.S. News & World Report. May 8, 2018. "Sometimes, Rebalancing Does More Harm Than Good." https://money.usnews.com/investing/buy-and-hold-strategy/articles/2018-05-08/is-portfolio-rebalancing-necessary Accessed Nov. 5, 2018.
[5] Ibid.
[6] Ibid.

Investing involves risk including the complete loss of principal.

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