WEALTH EFFECT

How to Rebalance Your Portfolio

A strategy that it can boost your returns as well as lower your risks.

By BRETT ARENDS

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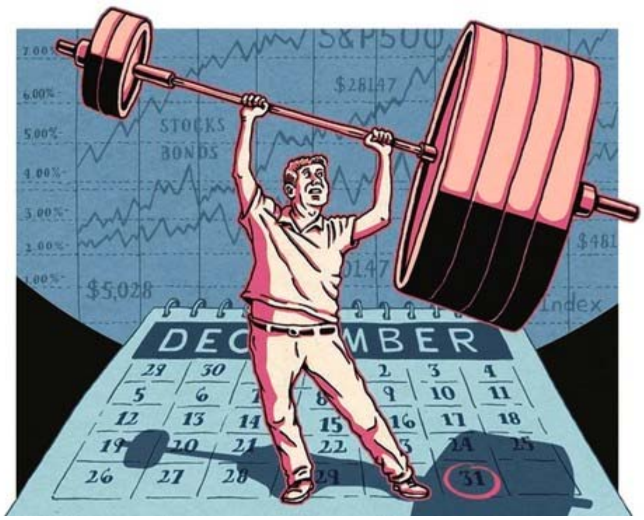

Andrew Roberts

Investors are constantly told to rebalance their portfolios. But many don't, and one reason is that they aren't sure when to do it.

WSJ Radio

Brett Arends and WSJ's Mathew Passy discuss the importance of rebalancing your portfolio

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Financial advisers have long recommended that investors reset their holdings periodically, cashing in some of their gains from their best-performing investments and using the money to buy more of the laggards.

The standard justification: to maintain your target balance between more volatile asset classes, such as stocks, and those traditionally seen as more stable, such as bonds and cash.

Investors seeking to follow that advice don't really need to act frequently. For Colleen Jaconetti, Francis Kinniry Jr. and Yan Zilbering, analysts at mutual-fund giant Vanguard Group, once a year is good. In a 2010 report, they found that rebalancing more often—such as once a quarter—did little to reduce volatility and portfolio drift, and had the potential to raise costs.

But there is another, less-well-known benefit to the exercise, experts say. In volatile markets, it can boost your returns as well as lower your risks—what is known as a "rebalancing bonus."

From January 1926 through December 1940—a period that includes the Great Depression—a portfolio of 100% U.S. stocks posted total returns, including reinvested dividends, of 81%, according to a 2012 report by Columbia Business School professor Andrew Ang. A portfolio of 100% U.S. government bonds returned 108%. But a portfolio of 60% stocks and 40% bonds, rebalanced quarterly, beat both by a wide margin, with a return of 146%.

An investor who rebalanced his portfolio quarterly effectively cashed out stock-market gains during the booms and put some of his profits into bonds, and then bought the stocks back, at much cheaper prices, during selloffs.

Mr. Ang found similar results looking at returns from January 1990 through 2011.

The wider your array of assets, the more independent they are of one another, and the more volatile the markets, the better the gains are likely to be, analysts say.

"Rebalancing is the simplest, and yet one of the most powerful, ways of buying low and selling high," Mr. Ang says. "The beauty of a good rebalancing policy is that it is automatic. Buying when prices are going through the floor is very difficult. Selling when prices continue to rise through the stratosphere is equally hard. Rebalancing forces you to do both."

There are costs to rebalancing, although they often are overestimated. Selling stocks, bonds or funds can trigger taxable capital gains—and gains realized on any investments held for less than a year are taxed at the higher rates applied to ordinary income. Trading also increases costs.

Yet investors who hold their portfolios in a tax-sheltered accounts, such as a 401(k) or individual retirement account, will avoid the taxes. And those who invest using a low-cost online brokerage firm may find their trading costs minimal.

Research has found that for institutional investors, the best strategy is to rebalance only when a portfolio drifts outside of an range—for example, if the proportion allocated to stocks drifts from 60% to below 55% or above 65%.

For retail investors, though, such a strategy involves a further cost: their time. It is far easier to remember to check your portfolio and make changes at set intervals than to monitor it constantly for drift.

Even though markets appear to twist and turn monthly, or even daily, the benefits of rebalancing more often may be surprisingly meager.

Consider an investor who 10 years ago placed equal amounts into five low-cost index funds: the Vanguard Total Stock Market Fund, which tracks U.S. stocks; the iShares MSCI EAFE exchange-traded fund, which tracks developed markets in Europe and Asia: the iShares MSCI Emerging Markets Index ETF; the Vanguard Inflation-Protected Securities Fund and the Vanguard Long-Term Treasury Fund.

The subsequent decade has been extremely turbulent for all five investments. This would appear to be a classic circumstance in which frequent rebalancing ought to have yielded significant gains. But it wouldn't have.

According to an analysis using Lipper Horizon, a portfolio-monitoring service from data provider Lipper, an investor who didn't rebalance this portfolio at all posted overall gains of 7.9% a year over the 10-year period, and a maximum fall in portfolio value, from 2007 through 2009, of 35%.

Investors who rebalanced quarterly, on the other hand, posted gains of 8.7% a year and a smaller maximum dip of 29%. But those who merely rebalanced at the end of each year saw even better annualized returns, of 9.0%, and a slightly smaller maximum decline of 28%.

The bottom line? It is wise to rebalance periodically. Doing it quarterly may be best, but those who rebalance once a year may not miss out on much of the benefit—or any at all.

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