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PORTFOLIO STRATEGY

# A Rebalancing Act

*A guide to getting your allocations back on track*

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"Rebalance your portfolio." It's the financial-advice equivalent of "eat your vegetables," "exercise regularly" and "use sunscreen."

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Richard Borge

And like those dictums, it is often ignored. In a Charles Schwab Corp. survey of American investors approaching retirement, published in November, 20% of respondents said they hadn't rebalanced their portfolio in the past five years or didn't know when they had last rebalanced; an additional 9% had never rebalanced.

But it's never too late to take a healthier approach to investing. Here's a guide to the benefits of rebalancing and how to do it.

## *The Basics*

In the simplest terms, rebalancing means adjusting your portfolio periodically to get back to your target allocations of stocks, bonds and other holdings. The purpose is to keep your investments from straying too far from your risk tolerance.

Over time, as a portfolio drifts away from its target allocations because of changes in the market value of your assets, the portfolio becomes either too risky or too conservative. For instance, a portfolio you set up at 60% stocks and 40% bonds may shift to 70% stocks and 30% bonds if there is a sustained rally in stocks—or to 40% stocks and 60% bonds in a bear market for stocks. To restore balance, assets that are underweighted in terms of the target allocations are bought, and overweighted assets are sold.

"It's a kind of strange exercise, if you think about," says Bill Allen, vice president of Charles Schwab's Private Client Investment Advisory affiliate. You sell the winners and buy the losers. "It's counterintuitive."

But that discipline, pushing you to buy low and sell high, is a big part of the benefit.

Rebalancing does have its costs. Buying and selling generate trading costs, and in taxable accounts you may owe capital-gains taxes on assets you sell. For some investors, those costs may be significant enough to limit the frequency or extent of rebalancing. "It's a balancing act," says Colleen Jaconetti, a senior analyst in Vanguard Group's Investment Strategy Group.

## *Two Strategies*

There are two broad approaches to rebalancing—calendar and threshold.

With the calendar approach, an investor rebalances according to a set schedule (usually monthly, quarterly or annually), regardless of how much—or how little—a portfolio has drifted from its target allocations. On the plus side, rebalancing on a schedule takes the emotion out of investing decisions. "You listen to the portfolio, not to the market," says Mr. Allen. But if allocations have changed only slightly, you may incur trading costs and tax-reporting hassles—and spend some time—without getting a lot of benefit.

In contrast, threshold rebalancing is triggered only when a portfolio's asset allocations change by a set degree. The common rule of thumb is a change of five percentage points in the weightings for the major asset classes in your portfolio. So, for instance, you would tweak your holdings if a strong stock market pushed your equity allocation from the targeted 60% to more than 65% of your portfolio—or if a market slump pushed it to less than 55%. You might also set separate, narrower bands for smaller slices within your portfolio—say, real-estate securities, or niches within your equity holdings, like emerging-markets stocks or small U.S. stocks.

The big advantage of the threshold approach: adjusting quickly to market movements that might significantly skew your exposure to risk if, for instance, you rebalance only once a year. The big drawback: You have to constantly monitor your portfolio to see when a threshold is breached. And a low threshold may mean a lot of trading and tax costs.

Whatever approach investors use, they should be sure to rebalance not just between major asset classes but also within each of those classes, says Sheryl Garrett, founder of the Garrett Planning Network, a network of fee-only financial advisers and planners. Say you have a 60% allocation for equities, with 20% of your portfolio invested in international growth stocks and 40% in U.S. stocks. If the international-growth allocation drifts down to 10% and the domestic-stock allocation rises to 50%, your overall equities allocation hasn't changed, but you have lost some diversification.

## *The Combination Approach*

Some advisers combine time and threshold strategies. For instance, you might review your portfolio every quarter but make changes only if an allocation is out of whack by a set degree. A Vanguard study found that for most investors an annual or semiannual rebalancing and a threshold of five percentage points produces a "reasonable balance" between controlling risk and minimizing costs.

An annual rebalancing with a threshold of five percentage points is where most Schwab advisers start, says Mr. Allen. But in the past couple of years, due to the volatility of the markets, more clients are rebalancing every six months on the recommendation of advisers, he says.

Many of the advisers in the Garrett Planning Network schedule an annual rebalancing but adjust the timetable if the client's risk tolerance changes, says Ms. Garrett.

She says many advisers are wondering if the standard five-point threshold is too low. "Some advisers are expanding that to 10%. Five percent could cause excessive trading, and that doesn't do anybody any good," says Ms. Garrett, who is based in Shawnee Mission, Kan.

Another way to avoid excessive trading is to use the five-point rule but bend it, says Walt Woerheide, a dean at American College in Bryn Mawr, Pa. For example, if you had a target of 60% for equities and that allocation drifted to 65%, you would sell enough stock to move the weighting back to 62%. "The economic term is satisfice"—a blend of satisfy and suffice—"meaning good enough," says Dr. Woerheide.

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