FinStart

How do you rebalance a portfolio?

Rebalancing means bringing your portfolio back to its original asset mix.

- The value of funds (mutual funds or ETFs) in your portfolio will not change at the same rate.
- Fixed income funds usually gain / lose less than equity funds.
- As a result, when the markets do well, you may end up with too much equity and too little fixed income than you originally intended (equity increased in value more than fixed income did).
- When the markets do poorly, you may end up with not enough equity and too much fixed income (equity declined in value while fixed income may have increased or declined less).

Financial planners suggest that you consider rebalancing if your allocations move by 5% or more from the target asset mix – for example to 80% when you targeted 75%. You should also consider rebalancing if you make a large withdrawal.

To rebalance your portfolio, in theory you'd sell down the ETFs / mutual funds that gained value and use the proceeds to buy more of those that are lagging. Here's an example of a two-ETF portfolio.

Method 1

- Since your equity ETF gained $1,500 (6000-4500) and your fixed income ETF lost $100 (1500-1400), after 1 year you have too much exposure to equities (81% rather than 75% you want).
- One way to deal with it is to sell $450 worth of the equity ETF shares and buy the same amount of your fixed income ETF (or a GIC). This will bring your asset mix to the original 75/25%.

	Original asset mix		After 1 year		After rebalancing	
Equity ETF	$4,500	75%	$6,000	81%	$5,550	75%
Fixed income ETF	$1,500	25%	$1,400	19%	$1,850	25%

Method 2

In practice, if you pay commission on buying /selling or even just on selling ETFs, you could do something else, assuming you have some new money to add to your investment.

- You could leave your equity ETF as is and use the new money (plus any cash from distributions sitting in your account) to buy $600 worth of additional shares of your fixed income ETF / a GIC.
- That would also save you some work as you'd only have to do one transaction.

	Original asset mix		After 1 year		After rebalancing	
Equity ETF	$4,500	75%	$6,000	81%	$6,000	75%
Fixed income ETF	$1,500	25%	$1,400	19%	$2,000	25%

One other thing to think about:

- Time your rebalancing in early January. Many funds pay distributions in December so, unless you have automatic DRIP, you'll have some new cash to use. January is also a good time to make RRSP contributions.
- In the meantime, accumulate the money you're saving in your savings account – they will earn some interest.

If you have a taxable account, Method 2 is better because, when your rebalancing involves selling funds that increased in value, you will incur capital gains and pay income tax on those gains at year end.