



Debbie Oswald

## Rebalancing: Effectively managing risk and market volatility

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As time goes by, and the markets go up and down, your portfolio commonly experiences gains in some areas and losses in others. Over time, this fluctuation can throw your asset allocation out of sync and increase your overall risk. When this happens, it's time to rebalance.

Rebalancing is the process by which you readjust your mix of assets to reflect your original goals and risk tolerance. Smart investors start with a set plan—establishing an initial asset allocation and assigning percentages of the portfolio to assets such as stocks, bonds, and cash, and perhaps other types of investments such as real estate and commodities. These allocations are then broken down into subcategories based on characteristics such as market capitalization, investment style, maturities, and credit quality.

From the onset, asset allocations should match the investor's investment goals and time horizon. For

example, an older investor nearing retirement will commonly have a more conservative mix of funds in their portfolio than a young married couple. As circumstances change, investors should also review their allocations to determine if they still meet their financial goals.

### Why Rebalance?

Why rebalance your portfolio when it doesn't match your original allocation? Why not go with the flow of the markets? Simply put, you may be taking on more risk than you bargained for.

In the early 1990s, for example, you may have started out with 55 percent in stocks and 45 percent in bonds. If you didn't rebalance your funds along the way, your allocations were probably very unbalanced by 1999—possibly 80 percent in stocks and 20 percent in bonds. Unfortunately, reality soon set in. Stocks—especially technology stocks—suffered significant losses as the stock market declined steeply from 2000 to 2002. Rebalancing these funds throughout the 1990s would have lowered your risk and losses significantly as the markets shifted.

### How Do I Rebalance?

For tax-deferred accounts, you can simply shift assets to restore your target allocation without paying any taxes. For example, if you see

significant gains in small-cap growth funds, thus increasing your percentage in this area by 5 to 10 percent, rebalancing your funds can lower the impact if this category falters. Of course, the small-cap growth funds may continue to soar, but is this a risk you are willing to take?

For taxable accounts, you should invest any new contributions to the under-weighted categories to avoid incurring unnecessary taxes. However, if a fund had exceptional results in one year, you may want to consider selling a portion of that fund and investing the proceeds in an under-weighted fund. By taking this step, you may incur some capital gains tax, but you would be protecting your gain and lowering volatility. If taxes will be incurred, try to minimize the impact by taking long-term capital gains (holding an investment more than one year) rather than short-term gains.

### When Should I Rebalance?

While rebalancing is itself a simple process, deciding when to rebalance and choosing a strategy isn't always so easy.

There are a variety of rebalancing approaches. The most common approach used by investors is periodic rebalancing. With periodic rebalancing, an investor commonly rebalances their asset allocation on a fixed schedule. This could be annually, semi-annually, or quarterly.

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This is the easiest method for rebalancing. However, this approach is somewhat rigid and doesn't allow investors to respond as quickly to changing opportunities in the markets.

Several rebalancing methods, often implemented by money managers, are considered to have more flexibility:

*Threshold Rebalancing*—shifting funds to meet the initial targets once the allocations exceed a certain agreed-upon threshold, such as 5 percent.

*Range Rebalancing*—while similar to threshold rebalancing, this approach calls for funds to be shifted to the maximum, not the target, allocation (possibly

as much as 5 percent more than the initial allocation) when an asset class rises or falls more than an allowed amount.

*Volatility-Based Rebalancing*—when volatility rises above a predetermined threshold, investors sell higher-volatility assets and purchase lower volatility assets. For example, if the market seems unsteady, investors may consider moving more funds into short-term bonds that are considered relatively low-volatility assets.

*Active Rebalancing*—assets are rebalanced to the target allocations as needed. This approach allows investors to take advantage of short-term market trends.

However, it may require more time and research than is feasibly possible for the individual.

Rebalancing has many benefits but it also has costs. Investors need to consider both in choosing the appropriate rebalancing strategy.

#### Is It Time?

Now that you understand the importance of rebalancing, talk to your financial professional about what approach is best for you. Your professional should be able to provide you with valuable guidance that can make the rebalancing process a simple, but important, step in your portfolio management.

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