

Rebalance Your Asset Allocation

By Deidra Fulton, CFP

Rebalancing is the process of modifying subsequent allocations back to target weightings. In its simplest form, rebalancing involves selling some of the holdings in asset classes that have become overweighted and using the proceeds for buying additional holdings in underweighted categories.

Reasons to Rebalance

Asset classes perform differently over given time periods, just as do individual investments. When the economy is performing well and credit is easily attainable, smaller and mid-sized capitalization companies may perform especially well. Large-cap companies — with their stronger balance sheets and greater diversification — may have the edge during periods with tighter credit and greater economic uncertainty. Bonds may hold a distinct advantage during recessionary periods. And international stocks may have an edge during periods when the domestic economy is pressured.

Here's why you should rebalance:

- ✓ **Distorted allocations:** Initially established asset allocations may become distorted over time and need occasional adjustments.
- ✓ **Risk:** Balanced diversification can help minimize risk. Although it's tempting to let a high flyer remain unbridled, doing so increases risk in the long run.
- ✓ **Improved returns over time:** Rebalancing helps minimize your portfolio's overall risk and improve returns over time.

You can choose one of several criteria as a standard for rebalancing:

- ✓ **Time period:** This method uses some predetermined interval of the calendar as the trigger for rebalancing, typically quarterly, semiannually, or annually. Asset class allocations are adjusted back to original target weightings at the selected calendar interval.

- ✓ **Absolute percentage weighting:** This method employs a simple standard for making future modifications: Rebalance at any point in the future when the actual asset class weightings have shifted from the original target allocations. Note that this method may result in almost constant rebalancing of your holdings — not to mention incurring higher trading costs — due to the continual movement of markets as a whole.
- ✓ **Tolerance window range:** This method allows for some judgment in deciding whether to rebalance. For example, you may have a threshold of 3 percent as your criteria for a tolerance window. If the weighting is more than 3 percent above or below your target weighting, you rebalance.
- ✓ **Combination:** For example, you can combine both a percentage tolerance window and an annual calendar interval. In that case, you may rebalance once a year if any holding is more than 3 percent off the original target.

Ways to Rebalance

There's no single correct approach for rebalancing. Regardless of the rebalancing method you use, you need to regularly review and adjust your portfolio's asset allocations to maintain proper diversification and reduce risk. Here are some common methods:

- ✓ **Sell and purchase:** Sell your overweighted investments and purchase underweighted ones.
- ✓ **Withdraw or invest:** Take regular withdrawals from overweighted categories or direct future investments to underweighted asset classes.
- ✓ **Redirect:** Redirect payouts, such as dividends or capital gain distributions, from holdings in overweighted asset classes to investments in underweighted asset categories.



During an uncertain economy, thinking about rebalancing may be even more difficult. Your gut instincts may be to cut and run. But to make money in the long term, it's essential to stick to the discipline. When the stock market is falling rapidly, selling bonds and buying stocks may just be the right thing to do because suddenly your portfolio is more heavily weighted in bonds and stocks are relatively cheap. Conversely, when the stock market is soaring, it's time to sell off some of your winners and buy bonds. Remember the old adage: Buy low and sell high. Sticking to the rebalancing discipline can help you accumulate wealth and hang on to it.

An Example of Rebalancing in Action

This section presents an example of rebalancing. Suppose your target asset class allocations are the following:

- ✓ **Large cap stocks:** 30 percent
- ✓ **Small cap stocks:** 15 percent
- ✓ **International stocks:** 25 percent
- ✓ **Long-term government bonds:** 5 percent
- ✓ **Intermediate-term government bonds:** 10 percent
- ✓ **U.S. Treasury bills:** 15 percent

Assume you invested \$100,000 at the beginning of 2005 and you rebalance annually, using a 3-percent tolerance window. Table 41-1 shows your original asset category weightings and the amounts invested by asset class.

<i>Asset Class</i>	<i>Target Weighting</i>	<i>Amount Invested</i>
Large-cap stocks	30%	\$30,000
Small-cap stocks	15%	\$15,000
International stocks	25%	\$25,000
Long-term government bonds	5%	\$5,000
Intermediate-term government bonds	10%	\$10,000
U.S. Treasury bills	15%	\$15,000

Table 41-2 shows the original amounts invested, returns for the year, the amounts invested by asset class at the end of 2005, the end weightings, and the original target weightings. Although weightings have changed, no category exceeds the 3-percent tolerance window, and no rebalancing is needed.

<i>Asset Class</i>	<i>Beginning Amount Invested</i>	<i>Returns by Asset Class</i>	<i>Ending Amount Invested</i>	<i>Ending Asset Class Weightings</i>	<i>Target Weighting</i>	<i>Adjustment Needed with 3% Window</i>
Large-cap stocks	\$30,000	4.9%	\$31,470	29%	30%	0
Small-cap stocks	\$15,000	5.7%	\$15,855	15%	15%	0
International stocks	\$25,000	14.0%	\$28,500	27%	25%	0
Long-term government bonds	\$5,000	7.8%	\$5,390	5%	5%	0
Intermediate-term government bonds	\$10,000	1.4%	\$10,140	9%	10%	0
U.S. Treasury bills	\$15,000	3.0%	\$15,450	14%	15%	0
Total	\$100,000		\$106,805	100%	100%	

Table 41-3 shows the year-end results following 2006.

<i>Asset Class</i>	<i>Beginning Amount Invested</i>	<i>Returns by Asset Class</i>	<i>Ending Amount Invested</i>	<i>Ending Asset Class Weightings</i>	<i>Target Weighting</i>	<i>Adjustment Needed with 3% Window*</i>
Large-cap stocks	\$31,470	15.8%	\$36,442	30%	30%	0
Small-cap stocks	\$15,855	16.2%	\$18,424	15%	15%	0
International stocks	\$28,500	26.9%	\$36,167	29%	25%	-4
Long-term government bonds	\$5,390	1.2%	\$5,455	4%	5%	1

<i>Asset Class</i>	<i>Beginning Amount Invested</i>	<i>Returns by Asset Class</i>	<i>Ending Amount Invested</i>	<i>Ending Asset Class Weighting</i>	<i>Target Weighting</i>	<i>Adjustment Needed with 3% Window*</i>
Intermediate-term government bonds	\$10,140	3.1%	\$10,454	8%	10%	2
U.S. Treasury bills	\$15,450	4.8%	\$16,192	13%	15%	2
Total	\$106,805		\$123,134	100%	100%	

* Applied to target asset class weighting for revised total portfolio value. Note that international stocks are now beyond the 3-percent tolerance window and have triggered the need for rebalancing. Notice further that three other asset classes are below their respective targets.

To rebalance, you sell international stocks and purchase intermediate government bonds and U.S. Treasury bills. Table 41-4 shows the updated portfolio.

<i>Asset Class</i>	<i>Ending Dollar Amount 2006</i>	<i>Adjustment Needed with 3% Window*</i>	<i>Adjustment (Dollars)</i>	<i>Revised Amount Invested</i>	<i>Revised Weighting after Rebalancing</i>	<i>Target Weighting</i>
Large-cap stocks	\$36,442	0.0%	\$0	\$36,442	30%	30%
Small-cap stocks	\$18,424	0.0%	\$0	\$18,424	15%	15%
International stocks	\$36,167	-4.0%	-\$5,384	\$30,783	25%	25%
Long-term government bonds	\$5,455	0.0%	\$0	\$5,455	4%	5%
Intermediate-term government bonds	\$10,454	2.0%	\$2,692	\$13,146	11%	10%
U.S. Treasury bills	\$16,192	2.0%	\$2,692	\$18,884	15%	15%
Total	\$123,134			\$123,134	100%	100%

* Applied to target asset class weighting for revised total portfolio value.