Coromandel Wealth Management

Portfolio Rebalancing in Today's Market: More Than a Formula

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The term "rebalance" makes investing sound as simple as having your tires rotated or your car's alignment checked. The basic concept behind this exercise is mostly straightforward.

However, interest rates are currently at historic lows and because of that, many investing experts say it has become harder to keep investment allocations in proper balance. With interest rates projected to stay low and/or volatile for the immediate future, what used to be a formula driven exercise has become even more challenging. For this reason, some of the traditional "equity versus fixed income" formulas need to be revisited, especially if interest rates go higher.

Rebalancing your investment portfolio is still a simple strategy, and it still makes sense to do this at regular intervals so your investments are closely aligned with your long-term financial plan. That generally means periodically reviewing your portfolio's mix of investments. After a market rise, many investors lighten the upside (and downside) potential of equities with hopefully less volatile returns of fixed income when one or the other gets overinflated in your portfolio. While rebalancing does not assure superior performance, it does keep portfolios closer to your targeted asset allocations and manage the level of portfolio risk.

What Is Rebalancing?

According to Investopedia.com, rebalancing is defined as the process of buying and selling portions of your portfolio in order to set the weight of each asset class back to its original state. In addition, if an investor's investment strategy or tolerance for risk has changed, he or she can use rebalancing to readjust the weightings of each security or asset class in the portfolio to fulfill a newly devised asset allocation.

The First Two Steps to Traditional Rebalancing

Traditional rebalancing usually has two simple steps. However, in today's market there is a third step that can be quite difficult.

Step One: When you design your investment plan, you decide your target mix of equity, income and alternative investments (real estate, precious metals, etc.) based on your personal situation, including your long-term goals and risk tolerance.

Step Two: As your investment portfolio's value changes, you need to check it periodically to see how your personal mix of investments move with market changes. You should then consider adjusting your holdings to reflect your personal situation by reviewing your goals, age and risk appropriateness. For many investors, tax time is one of the more popular times to perform this checkup.

When you complete your rebalance, your hope is to sell what has increased (and could potentially be high), and buy what has not performed as well (and is possibly low). Traditional rebalancing is supposed to give investors the discipline to attempt to do that. Currently, with many fixed income vehicles at artificially low rates, the old formula of shifting between stocks and bonds needs to be revisited during this process.

"I would move away from the price risk of bonds, and I would be worried about adding to them right now," says Charles Ellis, former chairman of the Yale Endowment. "I would be looking for other forms of income. When it comes to fixed income, you have to consider if I really need that, and if I can I get income in any other way."

In keeping a balanced portfolio, debt securities have nearly always provided a natural hedge. Historically, bonds have usually gained in value when stocks went down, and their yields have risen when stocks have gone up (mostly during an improving economy). For decades, rebalancing provided a virtuous circle that way, and as a result, it kept people from letting emotions rule investments, says Ellis. That rule still holds, even if the asset mix is changing.

The rule of thumb has traditionally been "your age minus 100." It tells you roughly how much equity you should have. Doing that math, at age 40, your equity should be 60 percent and the rest should be fixed income. At 60, those numbers are flipped, with 60 percent in fixed income and 40 percent in stocks. Thanks to Quantitative Easing, which has put interest rates at artificially low rates, and increasing life expectancies, this strategy may no longer be appropriate.

The Consequences of Imbalance

A popular belief among many investors is that if an investment has performed well over the last year, it should perform well over the next year.[1] Unfortunately, past performance is not always an indication of future performance. This is a fact that investments typically disclose, but many investors still remain heavily invested in last year's "winning" asset classes and may drop their portfolio weighing in last year's "losing" asset classes. Even worse, investors often "chase performance," buying an asset long after most of the gains have been realized. Remember, equities are more volatile than fixed-income securities, so the source of last year's large gains may translate into losses over the next year.

Normal rebalancing rules would suggest that with a large gain in stocks since the start of last year, investors should start lightening up on equities. At the same time, they should be switching to fixed income investments to restore that balance. However, bond yields are historically low today. Many investment experts are currently leery of loading up on more fixed income, especially with the Federal Reserve in its sixth year of keeping interest rates low, with rates expected to rise when the policy ends.

The New Third Step of Rebalancing

Step Three: When you design your investment plan, you decide your target percentage for fixed income assets. With interest rates artificially low, these types of investments can have an unusually high amount of "interest rate risk." According to Investopedia.com (bolding is mine):

"Interest rate risk affects the value of bonds more directly than stocks, and it is a major risk to all bondholders. ***As interest rates rise, bond prices fall and vice versa.*** *The rationale is that as interest rates increase, the opportunity cost of holding a bond decreases since investors are able to realize greater yields by switching to other investments that reflect the higher interest rate."*

Due to increased interest rate risks, investment professionals have looked elsewhere for income (e.g., REITs, MLPs, preferred and convertible stock). "Laddering" a series of short-term bonds can be another way to address this problem, since low-duration debt reaches maturity in a short time.

[1] Studies have demonstrated the existence of persistence in up- and down-side market performance known as "momentum", but it is difficult to execute properly, and can be extremely risky for the non-professional investor.

While one- to five-year securities pay little in yield, at least investors recover most or all of their invested capital when the security matures, unless they overpaid for the bonds in the secondary market.

Recently, dividend-paying stocks have begun taking up a larger share of the dollars earmarked for "income" in some allocations models. While may seem to make sense at a time when the average stock dividend on the Standard & Poor's 500 index is higher than the 10-year Treasury bond, it's not an even trade because stocks are still almost always more volatile than bonds.

Rebalancing Focuses on the Long Term

Despite the shifting views on how to rebalance in a low-rate environment, most financial advisers still see merit in the practice. High level financial strategists like Ellis, who guided Yale's massive endowment with a rebalancing strategy based on diversified investments, advise high-income investors to take pains to make sure they rebalance to suit their needs. Ellis says personal advice and individual goal-setting are key components of a successful rebalancing strategy.

The long term strategy behind a disciplined approach to rebalancing is to stick with asset allocations that you review on a periodic basis, and adjusting them with your age or as the needs of your life situation change.

Final Thoughts on Rebalancing Your Portfolio

Changes in an investor's lifestyle may warrant a change to his or her asset-allocation strategy. Whatever your preference, the following guideline provides the basic actions needed for rebalancing your portfolio:

1. **Track** - If you have recently decided on an asset-allocation strategy that is appropriate for you and have purchased the appropriate securities in each asset class, keep a record of the total weightings you are attempting to hold in each asset class. These numbers will provide you with historical data of your portfolio.

2. **Compare** - On a chosen future date, review the current value of your portfolio and of each asset class. Calculate the weightings of each holding in your portfolio by dividing the current value of each asset class by the total current portfolio value. Compare this figure to the original weightings. Are there any significant changes?

3. **Adjust** - If you find that changes in your asset class weightings have distorted your portfolio's exposure to risk, take the current total value of your portfolio and multiply it by each of the (percentage) weightings originally assigned to each asset class. The figures you calculate will be the amounts that should be invested in each asset class in order to maintain your original asset allocation. You may want to sell positions from asset classes whose weights are too high, and purchase additional investments in asset classes whose weights have declined. When selling assets to rebalance your portfolio, consider taking a moment to consider the tax implications of readjusting your portfolio. If you are adding new money to your portfolio, in some cases it might be more beneficial to simply not contribute any new funds to the asset class that is overweighed while continuing to contribute to other asset classes that are underweighted, thus reducing potential capital gains taxes.

Conclusion

Rebalancing your portfolio can help you maintain your original asset-allocation strategy and allow you to implement any changes you make to your investing style. Studies have shown that a good frequency for rebalancing is once a year, but this may vary depending on your transaction costs, personal preferences, changes in your life situation, and tax considerations, including what type of account you are selling from and whether your capital gains or losses will be taxed at a short-term versus long-term rate. This is where a qualified advisor can provide help.

The primary goal of rebalancing is to focus on managing an investors risk by staying within targeted allocations. It is not a method for maximizing your investment returns.

How often and how much of your portfolio you need to rebalance is where a qualified financial advisor can add value, as well as determining suitable asset allocation percentages for you. Essentially, rebalancing tries to help you stick to your investing plan regardless of what the market does.

Our goal is to understand our clients' needs and to monitor their portfolios. Our primary objective is to take the "emotion" out of investing for our clients. To discuss your specific situation, please call our office to schedule a complimentary financial check-up appointment. As always, we appreciate the opportunity to assist you in addressing your financial needs.

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Complimentary Financial Check-up

If you are not currently a client of Coromandel Wealth Management, we would like to offer you a complimentary, one-hour, private consultation with one of our professionals at absolutely no cost or obligation to you. To schedule your financial check-up, please call George Gagliardi at: (781) 728-9001.