Why Rebalance?

You probably know that your investment portfolio is being rebalanced on a regular basis, but you might not know why. Is it for higher returns? For maintaining the agreed-upon balance of investments that is in your risk tolerance comfort zone? Does rebalancing help manage portfolio risk?

The answer to the above is "yes," "yes," and "yes," but with a qualification. Rebalancing an investment portfolio is most importantly a form of discipline, a way to reduce the impact of those dangerous emotions of greed and panic on the investment process.

Rebalancing is necessary because all of the moving parts in your portfolio rise and fall at different times and degrees. During a bull market, stock prices rise faster than bond values, causing them to make up a larger percentage of the portfolio than you signed on for. Similarly, when the bear growls, stocks will fall faster than bonds, causing your portfolio to become more conservative. Real estate investments and commodities often rise or fall at different times than stocks or bonds, pulling your overall percentage allocations away from the target mix.

So what does rebalancing accomplish? When you rebalance, you're selling the assets that rose in price and buying the ones that went down. This discipline results, over time, in consistently buying when an asset goes on sale, and selling when the asset becomes more expensive.

There are three ways to rebalance. The easiest is to use whatever new money is coming into the portfolio, monthly or quarterly, to buy the assets that have gone down, allowing you to make consistently fine adjustments that keeps the portfolio at its prescribed allocations.

Another possibility is to rebalance at certain times of the year—every three, six or 12 months.

Or you could follow the most complicated process, and rebalance whenever assets deviate by more than certain set percentages from the baseline asset allocation.

A recent article on the Seeking Alpha website notes that rebalancing reduces portfolio volatility, because you are not allowing the stock allocation to rise in the

portfolio during bull markets (which would set you up for a bigger drop when the market rise turns into a bear market).

An illustration in the article, using a simple mix of 60% stocks and 40% bonds shows that rebalancing using the percentage deviation method would have led to higher overall returns from the beginning of 2000 to January 2016. It found that wider bands produced higher returns (and fewer rebalances), although of course there is no guarantee that this would be the case in the future.

But perhaps most importantly, rebalancing gives you back, over and over again, the portfolio that you expected when you started, the portfolio whose expected long-term returns are incorporated in your financial plan, the portfolio you were most comfortable with when the investment process was first discussed. And when it comes to making decisions in a time of crisis, having a rebalancing policy in place ensures that they will be made with discipline, rather than emotion.

Source:

https://seekingalpha.com/article/4075169-value-tactical-rebalancing?page=2