

The Vital Role of Rebalancing

If there is a universal investment ideal, it is this: Every investor wants to buy low and sell high. What if we told you there is a disciplined process for doing just that, and staying on track toward your personal goals while you're at it? Guess what? There is. It's called **rebalancing**.

Rebalancing: How It Works

Imagine it's the first day of your investment experience. As you create your new portfolio, it's best if you do so according to a personalized plan that prescribes how much weight you want to give to each asset class. So much to stocks, so much to bonds ... and so on. Assigning these weights is called **asset allocation**.

Then time passes. As the markets shift around, your investments stray from their original allocations. That means you're no longer invested according to plan, even if you've done nothing at all; you're now taking on higher or lower market risks and expected rewards than you originally intended. Unless your plans have changed, your portfolio needs some attention.

This is what rebalancing is for: to shift your assets back to their intended, long-term allocations.

A Rebalancing Illustration

To illustrate, imagine you (or your advisor) has planned for your portfolio to be exposed to the stock and bond markets in a 50/50 mix. If stocks outperform bonds, you end up with too many stocks relative to bonds, until you're no longer at your intended, balanced blend. To rebalance your portfolio, you can **sell** some of the now-overweight stocks, and use the proceeds to **buy** bonds that have become underrepresented, until you're back at or near your desired mix. Another strategy is to use any new money you are adding to your portfolio anyway, to buy more of whatever is underweight at the time.

Either way, did you catch what just happened? Not only are you keeping your portfolio on track toward your goals, but you're buying low (underweight holdings) and selling high (overweight holdings). Better yet, the trades are not a matter of random guesswork or emotional reactions. The feat is accomplished according to your carefully crafted, customized plan.

Portfolio Balancing: A Closer Look

We've now shared a simple rebalancing illustration. In reality, rebalancing is more complicated, because asset allocation is completed on several levels. First, we suggest balancing your stocks versus bonds, reflecting your need to take on market risk in exchange for expected returns. Then we typically divide these assets among stock and bond subcategories, again according to your

unique financial goals. For example, you can assign percentages of your stocks to small- vs. large-company and value vs. growth firms, and further divide these among international, U.S., and/or emerging markets.

One reason for these relatively precise allocations is to maximize your exposure to the right amount of expected market premiums for your personal goals, while minimizing the market risks involved by diversifying those risks around the globe and across sources of returns that don't always move in tandem with one another. We, and the fund managers we typically turn to for building our portfolios are guided by these tenets of **evidence-based investing**.

Striking a Rebalancing Balance

Rebalancing using evidence-based investment strategies is integral to helping you succeed as an investor. But like any power tool, it should be used with care and understanding.

It's scary to do in real time. Everyone understands the logic of buying low and selling high. But when it's time to rebalance, your emotions make it easier said than done. To illustrate, consider these real-life scenarios.

- **When markets are down:** Bad times in the market can represent good times for rebalancing. But that means you must *sell* some of your assets that have been doing okay and *buy* the unpopular ones. The Great Recession of 2007–2009 is a good example. To rebalance then, you had to sell some of your safe-harbor holdings and buy stocks, even as popular opinion was screaming that stocks were dead. Of course, history has shown otherwise; those who did rebalance were best positioned to capture available returns during the subsequent recovery. But at the time, it represented a huge leap of faith in the academic evidence indicating that our capital markets would probably prevail.
- **When markets are up.** An exuberant market can be another rebalancing opportunity – and another challenge – as you must sell some of your high flyers (selling high) and rebalance into the lonesome losers (buying low). At the time, this can feel counterintuitive. But disciplined rebalancing offers a rational approach to securing some of your past gains, managing your future risk exposure, *and* remaining invested as planned, for capturing future expected gains over the long-run.

Costs must be considered. Besides combatting your emotions, there are practical concerns. If trading were free, you could rebalance your portfolio daily with precision. In reality, trading incurs fees and potential tax liabilities. To achieve a reasonable middle ground, it's best to have guidelines for when and how to cost-effectively rebalance. If you'd like to know more, we're happy to discuss the guidelines we employ for our own rebalancing strategies.

The Rebalancing Take-Home

Rebalancing using evidence-based investment strategies makes a great deal of sense once you understand the basics. It offers objective guidelines and a clear process to help you remain on

course toward your personal goals in rocky markets. It ensures you are buying low and selling high along the way. What's not to like about that?

At the same time, rebalancing your globally diversified portfolio requires informed management, to ensure it's being integrated consistently and cost effectively. An objective advisor also can help prevent your emotions from interfering with your reason as you implement a rebalancing plan. Helping clients periodically employ efficient portfolio rebalancing is another way Optima Asset Management seeks to add value to the investment experience.