

Why Rebalancing Your Portfolio Makes Sense

If you play blackjack or poker, there's a sound strategy for success. Once you have accumulated a stack of chips, take your winnings off the table. That way, you'll wind up ahead regardless of the outcome of the rest of the hands.

As an investor, you can use a variation of that strategy called "rebalancing" to reduce the overall risk to your portfolio. The idea is to shift funds away from outperforming assets and into other categories. For example, the U.S. stock market has risen to new heights and the closely watched Dow Jones Industrial Average has surpassed 15,000 for the first time in history.

Let's say you started the year with 50 percent of your portfolio in stocks, 40 percent in bonds and 10 percent in other categories, such as real estate or managed futures. Driven by the strong rise in U.S. equities, your overall portfolio may have increased 10 percent in value this year – an outstanding performance by any standard.

However, that increase in stock prices has also shifted the composition of your investment portfolio, perhaps to 60 percent of its total value in stocks, 32 percent in bonds and 8 percent in alternatives. While that might not sound like a big difference, the positive rise in equities has also increased your exposure to a potential downturn if the stock market makes a U-turn.

Therefore, a savvy investor, often with the help of a financial advisor, will consider taking steps to rebalance that portfolio and reduce the risk of a significant loss of equity values. On the practical side, that would mean selling some of those equities (or mutual fund shares) and putting that money into bonds or alternatives in order to get back to the 50-40-10 balance you had in January.

Regular rebalancing of your portfolio is one of the best ways to keep yourself on course. After all, the reason for having that original asset allocation is to match your risk tolerance as well as your goal for a rate of return.

But rebalancing your portfolio requires using mental discipline because it involves selling assets that have gone up in value – the "winners" – and buying other assets that haven't done as well. Many investors make decisions based on their emotions, which tell them to hang on to a stock (or other asset class) that has gone up in value. In fact, they would rather sell the "losers" and buy more of whatever asset is rising at the time.

There are two big problems with this emotion-based investment strategy. First, it costs more money to buy assets that have gone up in value. Rather than the classic "buy low, sell high" strategy, these investors are hoping to "buy high and sell even higher" – a risky approach.

Second, putting more money into your winners leads to overconcentration on a certain type of asset in your portfolio. For instance, you could wind up with a portfolio with 85 percent of its value in stocks, 10 percent in bonds and 5 percent in alternatives, which would be a long distance from the original 50 percent allocation to stocks. As a result, these investors are at risk for a substantial loss of principal if stocks turn downward.

Since certain assets historically do better than others at different times of

the market cycle, maintaining a balanced portfolio can deliver smoother performance over the long term. Rebalancing your portfolio when the market has moved it out of whack can help you stay focused on your original investment goals, such as achieving a certain level of overall returns with the amount of risk you're comfortable taking.

Of course, there are other ways to rebalance your portfolio as well. For instance, you and your financial advisor could take a more active approach, looking for "tactical" opportunities in the market. If conditions look right for a certain type of asset class to appreciate in value over the next few months, for instance, you might shift more money into that sector in search of a slightly higher overall return. On the other hand, if you expect a certain asset class to do poorly, you might shift money out of that sector to reduce your exposure to a potential loss. These tactical changes should be minor, and never "bet the farm" on one investment or asset class.

So, think about the benefits of building a diversified portfolio that includes the various rebalancing strategies. After all, investing is not a one-time strategy that you can put on autopilot – it's a process that never comes to an end.

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