

# HEADWATER INVESTMENT CONSULTING, INC.

*Registered Investment Advisor*

## *Part 3 of 3 in a Special Article Series: Managing Risk*

*So far in our Special Article Series: Managing Risk, we have examined how to determine your risk tolerance and how the stock-bond decision drives your portfolio's long-term performance. Next we discuss the importance and purpose of rebalancing your portfolio.*

## REBALANCING ACT

Portfolio diversification gives investors a valuable tool for managing risk and volatility in a portfolio. But smart diversification has an important side effect. It requires maintenance.

In a given period, asset classes experience divergent performance. This is inevitable and, in fact, desirable. A portfolio that holds assets that do not perform similarly (i.e., with low return correlation) will experience less overall volatility. That results in a smoother ride over time. However, dissimilar performance also changes the integrity of your asset mix, or allocation—a condition known as “asset drift.” As some assets appreciate in value and others lose value, your portfolio's allocation changes, which affects its risk and return qualities. If you let the allocation drift far enough away from your original target, you end up with a different portfolio.

Once you form a portfolio to match your current investment goals and risk tolerance, you should preserve its structural integrity since asset allocation accounts for most of a portfolio's return.<sup>1</sup> To efficiently pursue investment goals, you must manage asset drift.

Rebalancing is the remedy. To rebalance, you sell assets that have risen in value and buy more assets that have dropped in value. The purpose of rebalancing is to move a portfolio back to its original target allocation. This restores strategic structure in the portfolio and puts you back on track to pursue long-term goals.

### **Why rebalance?**

At first glance, rebalancing seems counter-productive. Why sell a portion of outperforming asset groups and acquire a larger share of underperforming ones? Intuition might suggest that selling previous winners may hinder returns in the future. This logic is flawed, however, since past performance may not continue in the future—and there's no reliable way to predict future returns.

Equally important, remember that you chose your original asset allocation to reflect your risk tolerance, investment goals, and time horizon. Rebalancing realigns your portfolio to these priorities by using structure, not recent performance, to drive investment decisions. Periodic rebalancing also encourages dispassionate decision making—an essential quality during times of market volatility. Moreover, if and when your overall financial goals or risk tolerance change, you have a foundation for making adjustments. In the absence of a plan, adjustments are a matter of guesswork.

## Challenges and decision factors

In the real world, portfolio allocations are usually complex, incorporating not only fixed income and equity, but also the multiple asset groups within equity investing. The more complex a portfolio's allocation, the greater is the need for maintenance.

Determining when and how to effectively rebalance requires careful monitoring of performance and awareness of your tax status, cash flow, financial goals, and risk tolerance. Rebalancing also incurs transaction fees and potential capital gains in taxable accounts. Thus, while there are good reasons to rebalance, the benefits must outweigh the costs.

Given these challenges, a practical rebalancing approach will establish asset drift triggering points while leaving enough flexibility to manage costs effectively.

Defined trigger points help investors decide when to rebalance. Most experts recommend rebalancing when asset group weightings move outside a specified range of their target allocations. This may be widely defined according to the stock-bond mix, or more appropriately, according to a percentage drift away from target weightings for categories such as small cap stocks, international stocks, and the like.

While rebalancing costs are unavoidable, several strategies can help minimize the impact:

- Rebalance with new cash. Rather than selling over-weighted assets that have appreciated,

use new cash to buy more under-weighted assets. This reduces transaction costs and the tax consequences of selling assets.

- Whenever possible, rebalance in the tax-deferred or tax-exempt accounts where capital gains are not realized.
- Incorporate tax management within taxable accounts, such as cost basis management, strategic loss harvesting, dividend management, gain/loss matching, and similar considerations.

Rebalancing incurs real costs that can detract from returns. At Headwater Investment Consulting, we define the range of acceptable asset drift in each client's Investment Policy Statement (IPS). We also adopt cost-saving strategies during rebalancing, paying particular attention to tax-sensitive transactions. In helping our clients rebalance, we strive to develop a structured plan that remains flexible to each individual's unique blend of goals, risk tolerances, cash flow, and tax status.

## Summary

No one knows where the capital markets will go—and that's the point. In an uncertain world, investors should have a well-defined, globally diversified strategy. Rebalancing is a crucial tool when implementing this plan.

*The information presented above was prepared by Dimensional Fund Advisors, a non-affiliated third party.*

## Endnotes

<sup>1</sup> Gilbert L. Beebower, Gary P. Brinson, and L. Randolph Hood, "Determinants of Portfolio Performance," *Financial Analysts Journal* 42, no. 4 (July/August 1986): 15-29. Gilbert L. Beebower, Gary P. Brinson, and Brian D. Singer, "Determinants of Portfolio Performance II: An Update," *Financial Analysts Journal* 47, no. 3 (May/June 1991): 40.

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