IS YOUR INVESTMENT PORTFOLIO 'OFF-BALANCE'?

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The investment markets have gone through another wild year—fortunately, this time, the volatility was generally in a positive direction. But the dramatic swing in stock returns after three bear years, along with dramatic swings in some other types of assets, again raises a question all investors should answer every year: do I need to rebalance my portfolio?

Rebalancing a portfolio involves periodically readjusting its mix of assets. Smart investors start by establishing an initial asset allocation, assigning percentages of the portfolio to assets such as stocks, bonds and cash, and perhaps other types of investments such as real estate and commodities. The allocations are further broken down by subcategories, such as different types of stocks and bonds.

The target allocations should be appropriate for that investor's investment goals and financial circumstances, as well as comfort level with certain types of investments. Someone older with no children and nearing retirement, for example, will likely have a different mix than a family in its early accumulation years. Smart investors also readjust the target allocations to reflect major changes in their personal financial circumstances (but not changes in the markets).

Why rebalance just because a portfolio no longer matches its original allocation? Why not just let it ride—especially if the market's going up? Because if you don't, you increase the risk that you won't achieve your investment goals. Say you had 55 percent in stocks and 45 percent in bonds in the early 1990s. Unless you rebalanced along the way, by the end of 1999, that mix might have become "unbalanced"—say, 80 percent in stocks and only 20 percent in bonds.

You know what happened next. This stock-heavy portfolio, especially if it was loaded of tech stocks, suffered more when the stock market declined steeply over the next three years than it would have had it maintained its original 60/40 balance through periodic rebalancing.

Now let’s look at your portfolio in the wake of the big returns of 2003. Large-cap stocks represented by the Dow and the S&P 500 gained over 28 percent on a total return basis last year. The tech-oriented Nasdaq climbed a staggering 50 percent in value, and real estate investment trusts returned over 38 percent. Many international stocks did well, as did gold and other commodities. Meanwhile, bonds stumbled, with the exception of “junk” bonds, which soared 29 percent in 2003, according to the Lehman Brothers U.S. High Yield Index.

What impact did these major market changes have on your portfolio? Did they alter your original asset allocation? How much did they alter the mix, and should some of the investments be rebalanced?

For sake of an example, let’s say your original portfolio designed ten years ago was 50 percent stocks, with allocations to various subcategories such as large-cap, small-cap, growth, value and international. Another 25 percent was in bonds (long-term, intermediate, short-term and junk), 10 percent in real estate through REITs, 5 percent in gold and 10 percent in cash. Let’s also assume that mix is still right for your needs.

Now calculate your current portfolio mix. Have large caps grown disproportionate to other categories of stock? Perhaps of the 25 percent you had in bonds, 5 percent was to be in junk bonds. But after their booming year, they now represent ten percent. Three out of the last four years have been very good for REITs—are they now overweighted in your portfolio? What if the real estate market stumbles in the coming year? Then the portfolio will take a bigger hit because you’re too heavy in REITs, just as it did in 2000–2002 due to overweighting in stocks.

How much to allow a specific asset category to shift before readjusting it is up to you, but a common guideline is five percent. To rebalance, consider directing future investment funds into those underrepresented categories until it’s back in balance. You also can readjust by selling off some of the overrepresented assets (the winners) and buying the underrepresented (the losers)—selling high and buying low. It is usually better to execute this strategy within tax-favored accounts to avoid taxes on gains, but if you need to rebalance taxable accounts, don’t let tax concerns derail you.

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