Retirees, here's how to rebalance your portfolio

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Pre-retirees and retirees are often told — especially this time of year — to rebalance their portfolios. Rebalancing is, of course, the process of selling this and buying that so that your assets are allocated according to your investment plan, such as 60% stocks and 40% bonds.

Oftentimes, especially in years such as 2014, allocations get out of whack. In fact, an investor who started 2014 with a traditional 60% stock/40% bond portfolio would have had a 62% stock/38% bond portfolio by year's end. And that sort of asset allocation might warrant, according to some experts, a rebalancing.

"Rebalancing periodically is a good way to maintain a well-diversified, risk-appropriate portfolio, particularly when markets are volatile," says Christopher Jones, chief investment officer of Financial Engines, a financial adviser based in Sunnyvale, Calif.

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Others agree. "Rebalancing is a good idea, particularly if you haven't done so in a while," says Jerry Miccolis, a principal and chief investment officer with Giralda Advisors in Madison, N.J., and author of *Asset Allocation for Dummies.*

Why so? "Left unattended, your asset allocation can get seriously out of whack," says Miccolis. "If you haven't rebalanced back to your target weights by asset class in over a year, you are likely overweight in U.S. equities, given their sustained bull run since early 2009, and therefore your portfolio is likely more risky than you had planned."

But rebalancing is easier on paper than in reality. In essence, it means selling your winners and buying your losers. And that's not so easy to do. "When the market is performing well, there can be a temptation to 'ride winners,' but doing so means you could be taking on more risk than you had originally planned," says Jones.

Plus, rebalancing isn't necessarily an easy concept to grasp. "Rebalancing is poorly understood — not just by investors but also by investment advisers," says Campbell Harvey, a professor at Duke University's Fuqua School of Business and co-author of a paper about risk, *Rebalancing Risk* (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2488552).

William Bernstein, the author of *The Investor's Manifesto,* agrees: "Rebalancing is one of the thorniest questions in finance."

Use the calendar. According to Bernstein, there are two main approaches to rebalancing. One is based on the calendar. Investors rebalance based on some predetermined schedule: quarterly, annually or every two to three years.

Bernstein favors this approach. "For the ordinary investor, annual will do very well, thank you," he says. "Every two or even three years, if you can remember that far ahead, is even better, since asset classes tend to exhibit short-term momentum and long-term mean reversion."

Other experts, however, aren't so fond of the calendar approach. "A naïve rebalancing strategy, such as rebalancing on the last day of the quarter or the year, introduces extra risk into your portfolio," says Harvey. "For example, the equity market may be in a free fall and your naïve rebalancing strategy will buy more equity leading to greater losses. Similarly, the equity market may be in a rally and the naïve strategy will be selling equity all the way up. The naïve strategy adds what we call 'negative convexity,' which simply means bigger drawdowns and bigger risk."

At a minimum, whether you rebalance or not based on dates in the calendar, check on a regular basis how your assets are allocated. "The key is to review your portfolio at least a few times a year to make sure that market performance hasn't changed your desired risk level or reduced your diversification," says Jones.

Use thresholds. The other approach to rebalancing is based on some threshold being reached. Investors rebalance when the percent invested in certain asset classes has exceeded certain bounds.

But this approach, says Bernstein, "is, as you might expect, vastly more complex, since to do it well you have to constantly monitor the portfolio and fix different thresholds for different asset classes."

Among the complexities, for instance, the thresholds have to be wider for more volatile asset classes. (Typically, an investor using this approach might rebalance when a portfolio rises or falls by more than 5 percentage points or 20% from its target allocation.)

For example, if your target allocation for a particular asset class is 10%, and it has drifted to less than 8% or greater than 12%, then it's time to rebalance, says Miccolis.

Use current market conditions. According to Miccolis, there is, for better or worse, no optimal fixed schedule. "The best time to rebalance is when your portfolio needs it," he says.

Harvey's research advocates for a rebalancing strategy that doesn't use fixed dates. "The rebalancing decision depends on current market conditions not the calendar," Harvey says.

Bad timing better than not rebalancing. To be fair, Miccolis says, no rebalancing schedule is ideal in all situations. "However, an imperfectly timed rebalanced schedule is better than no schedule at all," he says. "Rebalancing generally results in a portfolio with a better risk/return profile than an unattended buy-and-hold portfolio over time. It may feel uncomfortable as you're doing it, since you'll be trimming your winners and buying more of your laggards, but think of it as a self-imposed discipline to buy low and sell high, over and over again."

Use new investment dollars. Another way to bring your portfolio back to its target allocation is to invest new investment dollars in those funds and investments that are below their target allocation. "This forces a person to 'buy low,' which is counterintuitive in real time," says Craig Israelsen, an executive-in-residence in the financial planning program at Utah Valley University in Orem, Utah, and developer of the 7Twelve Portfolio. "In other words, rebalancing feels like we are rewarding the worst-performing funds by giving them the new investment dollars. Ah, therein lies the magic — that's what buying low is."

Delegate. Of course, there's one big problem investors face when it comes to rebalancing. "A lot of investors aren't very disciplined about reviewing and making adjustments to their portfolios, says Jones.

What to do given that? One, you could have your account professionally managed by an adviser such as Jones' firm, Financial Engines. Doing so, he says, "frees you from the responsibility of monitoring and adjusting your portfolio as the market shifts." With a managed account, professionals make trades on behalf of the individual investor.

Experts also say investing in target-date funds can help you rebalance your portfolio. "Target-date funds, which have asset allocations based on an investor's time horizon, are now nearly universally available and can help ensure that they have an appropriate retirement portfolio and these funds do not require any rebalancing," says Rob Austin, director of retirement research at Aon Hewitt in Charlotte.

Use automation. Investors and especially 401(k) plan participants can take the emotion out of rebalancing their portfolios by using automation, says Austin.

"Features that automatically buy and sell funds to rebalance to an appropriately defined portfolio ensures that the allocation remains suitable and at the same time, takes the emotion out of having to manually make changes," Austin says. "Rebalancing to a preset portfolio also means that individuals will sell funds that have grown and buy funds that are lower priced than before — a not-so-secret code for 'buying low and selling high.'"

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