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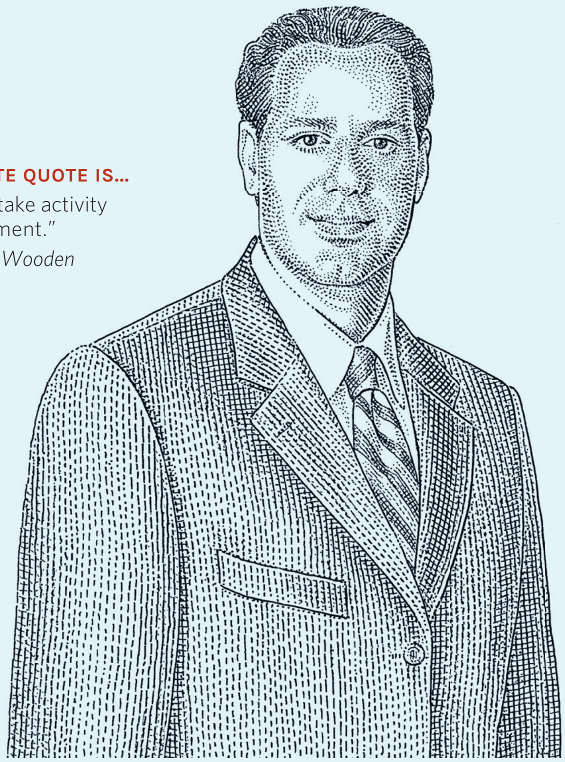
How can portfolio rebalancing keep you from veering off course on the bumpy road of today's volatile markets?

BY THEODORE E. SAADÉ

MY FAVORITE QUOTE IS...
"Do not mistake activity for achievement."
–Coach John Wooden



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Nearly everyone is familiar with the underlying rationale behind portfolio rebalancing. Over time, especially during extended bull or bear markets, allocations can significantly drift from their original targets.

Without rebalancing, the risk-versus-return characteristics of a portfolio become misaligned with the investor's long-term goals and risk tolerance.

Perhaps no better example can be found than in the bursting of the dot-com bubble during 2001. At the peak of the market run-up in March 2000, a typical 60/40 stock-to-bond portfolio that had not been rebalanced would have seen its equity allocation climb to 74 percent, while its bond holdings fell to 26 percent.

That's the reason why, when the bubble inevitably burst, so many investors felt the impact of the stock market plummet so intensely. More recently, nearly identical allocation shifts could be seen during the pre-financial crisis run-up to the October 2007 market peak and subsequent 17-month drop.

And, what about the choppy markets we have experienced of late? Given the potential adverse tax ramifications of buying and selling securities in order to rebalance a portfolio, is it still a smart strategy for volatile markets?

I believe the answer is a resounding yes. First, while market volatility has been high (often as the result of major economic triggers like Brexit), the long-term trend since March 2009 has been a steady upward progression (a seven-plus-year bull market). That's prompted a strong likelihood for allocation drift and subsequent heightened risk in portfolios that haven't been rebalanced.

The second reason for rebalancing lies with the multiple approaches to rebalancing which can reduce adverse tax consequences that might otherwise be generated by that undertaking.

FOUR TAX-SMART APPROACHES TO REBALANCING

While monitoring of your portfolio allocations should be a regular, periodic event (I'd suggest every six months), rebalancing needn't be. Rather than initiating a frequency-based rebalancing, a trigger-driven approach may be more advantageous.

For the previously mentioned 60/40 portfolio, consider setting an allocation drift threshold (e.g., ±5 percent), with anything beyond that triggering a rebalancing, yet still allowing for short-term market volatility.

Instead of opting to reinvest dividends and interest in the same securities already overweighting your portfolio, consider sweeping all your portfolio cash flows into a money market fund. That way, when triggers necessitate a portfolio rebalancing, these funds can be funneled toward the purchase of securities in the underweighted asset class(es) to help minimize or eliminate the need for taxable sales.

Don't make the mistake of looking at your taxable portfolio in a vacuum. Even if target allocations in a taxable portfolio drift beyond acceptable risk limits, those limits may be offset by a reallocation of assets within your retirement accounts, without any tax impact. Similarly, if you're retired and generating income through required minimum distributions, you can facilitate the rebalancing process by selecting your most profitable investments to draw down.

Lastly, investors with strong philanthropic inclinations may want to consider gifting highly appreciated stocks that have most contributed to a portfolio's allocation drift. It's a simple but effective approach that helps restore target allocations without requiring any stock sales.

OVERWEIGHT? UNDERWEIGHT? DON'T WAIT.

Above all, remember that the fundamental goal of rebalancing is not to make more money, but to control your exposure to risk. If you're investing near a market peak, however, that mitigation of downside risk can quickly translate to meaningfully enhanced portfolio value.

We are now more than 2,700 days into the second longest bull market in U.S. history. And while leading economic indicators still appear mixed-to-positive, corrections are inevitable. Now is the time to meet with your financial advisor to reevaluate your actual-versus-target portfolio allocations and determine a rebalancing strategy that makes sense. ●

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ABOUT US

THEODORE E. SAADÉ HAS BEEN IN THE FINANCIAL SERVICES INDUSTRY SINCE 1995. HE JOINED SIGNATURE ESTATE & INVESTMENT ADVISORS, LLC IN 1997 AS THE FIRM WAS OPENING ITS DOORS. In less than 10 years, SEIA reached the milestone of $1 billion in assets under management. Theo is a certified financial planner, accredited investment fiduciary and a chartered mutual fund counselor. He received a bachelor's degree in economics with a specialization in biochemistry from the University of California–Los Angeles. Theo specializes in overall wealth and investment management strategies for affluent individuals, foundations and corporations, and he is known for adhering to the saying: "strategy is my specialty, integrity is my responsibility." A longtime resident of Los Angeles, he is involved in multiple charities throughout Southern California. ●

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