$ Investment GUIDE with Eric Tyson

Questions & Answers for Financial Success

Rebalancing Your Investments

Question

Should we be rebalancing our retirement investments? With the financial turmoil, making changes has me scared of doing something wrong. Also, how often should we rebalance?

Answer

Suppose you have $100,000 invested for your retirement in an asset allocation of 60 percent stocks and 40 percent bonds. And further suppose that, during the next two years, stocks drop 50 percent in value, while your bonds produce a total return of 10 percent. Here's what will happen to your asset allocation in the absence of any changes from you:

- *Starting Mix:*
  stocks $60,000 / bonds $40,000
- *Mix After Two Years:*
  stocks $30,000 / bonds $44,000

So, after two years, instead of having 60 percent in stocks and 40 percent in bonds, you now have about 41 percent in stocks and about 59 percent in bonds. To return to your original chosen allocation, you would need to move about $14,400 out of bonds and into stocks. Making such a change is called "rebalancing."

- *Starting Mix:*
  stocks $60,000 / bonds $40,000
- *Mix After Two Years:*
  stocks $30,000 / bonds $44,000
- *Mix After Rebalancing:*
  stocks $44,400 / bonds $29,600

Now, most sane and sensible people might ask why you would take money from an investment that is

doing well (bonds) and put some of that into an investment that is doing poorly (stocks). The reasons are: first, to get your investment plan back on track; and second, to take advantage of the inevitable rebound that stocks should eventually enjoy.

Rebalancing is a rather clever system that disciplines you to buy low and sell high. Here are some important tips to make the most of and be smart about rebalancing:

Beware of tax consequences. If you're selling investments outside retirement accounts and those sales trigger realized profits, you will owe tax on those profits. That's why rebalancing is best done with money inside retirement accounts, where you needn't be concerned with tax consequences on transactions.

Beware of transaction costs. With most no-load mutual funds and exchange-trade funds, this isn't an issue, but it will cost you to trade most other investments. That doesn't mean you shouldn't rebalance if you will pay some transaction costs. It does mean that you should fully understand trading fees before you take action.

Find ways to rebalance by not making unnecessary trades. You can avoid transaction and tax costs through rebalancing with distributed investment income (interest and dividends), new contributions, and planned withdrawals.

Select a sensible rebalancing period/trigger. Numerous studies have shown that the benefits don't outweigh the costs when rebalancing is done frequently – such as monthly or quarterly. Those studies and my experience suggest that the best approach is to review your portfolio at least one to two times per year, and rebalance if your investment allocations have moved off base by at least five percent. So, for example, if you have 60 percent in stocks and 40 percent in bonds, if the stock allocation gets to 55 percent or 65 percent, or the bond allocation gets to 35 percent or 45 percent, you should rebalance. N

*Eric Tyson is a best-selling author (*Personal Finance for Dummies, Investing for Dummies, Mutual Funds for Dummies, Home Buying for Dummies*). He is read by more than four million people nationwide. A management consultant to Fortune 500 financial service firms, he also founded a counseling firm providing financial advice to non-wealthy investors, teaching that "one must live within one's means as a prerequisite to building wealth."*