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PLANNER RESOURCES

REBALANCING IN A BEAR MARKET

Investors have learned the hard way since early 2000 the importance of having a well-diversified portfolio. What they may not have yet learned is the importance of maintaining that diversification through periodic rebalancing.

The diversification lesson is pretty clear: investors took it on the chin when they overconcentrated on tech stocks or their employer's stock while ignoring bonds, cash and other assets such as real estate (bonds and real estate have done especially well during the bear market). But it's not just a matter of diversifying your portfolio and leaving it at that. You need to keep it diversified through periodic rebalancing; otherwise, the market will "rebalance" it for you.

Consider these numbers from the Schwab Center for Investment Research. Imagine a portfolio that was invested 60 percent in the S&P 500 stock index and 40 percent in Lehman Brothers aggregate bond index at the start of 1996. Four years later, because of the annual double-digit run up in large-cap stocks, the allocation for the portfolio, assuming no rebalancing, would have shifted to 75 percent for stocks and only 25 percent for bonds.

Clearly, leaving the portfolio alone was great for buy-and-hold investors during the bull market. Investors who rebalanced periodically during that period to maintain the 60/40 allocation would not have done as well, according to Schwab-until the market went south. As it turns out, investors who rebalanced periodically from 1996 through 2001 would have fared better than investors who'd let it ride.

The challenge for rebalancing is that the investor must do something that commonly goes against his or her grain. During bull markets, rebalancing forces them to sell off some of their winners (say growth stocks), or at least quit buying them, in order to buy lagging alternative assets. But at least investors recognize that this forces them to use the smart strategy of selling high and buying low.

Rebalancing is a tougher psychological concept during bear markets. Now investors are selling, or not buying, better performing assets in order to buy losers. To see the benefit of this, let's go back to our Schwab example. With the decimated stock market, large-cap stocks probably make up less than the original 60 percent allocated and bonds probably make up more than 40 percent, particularly in cases where investors dumped stocks and fled heavily into bonds. But numerous observers caution that this raises a new risk. Falling interest rates over the last two years are what primarily have been boosting returns for bonds and bond mutual funds (bond prices and yields move in opposite directions). But with interest rates at record lows, they are not likely to drop much more, and in time will almost certainly rise. Consequently, many investment experts worry that investors are loading up on bonds at a potentially bad time-just as investors were loading up on stocks at the other end of the cycle.

Rebalancing to the investor's original 60/40 allocation would reduce the impact of a future decline in the

bond market and keep the investor in stocks during a time when they might rebound. That's how rebalancing both reduces an investor's risk and, usually over time, produces superior average returns in volatile markets.

So how best to rebalance? Start with a diversified portfolio and a definite plan that states what portion of your portfolio you want invested in each investment category based on your goals, financial circumstances and tolerance for investment risk. For example, you might start with 55 percent stocks, 30 percent bonds, 10 percent real estate and 5 percent cash.

The next decision is how to maintain this mix through rebalancing. Some advisors recommend rebalancing once a year if the portfolio needs it. Another common method is to readjust whenever any given category exceeds its allocation by a certain percentage, such as five or ten percent. Keep in mind this readjustment can include subcategories, such as the percentage you have in growth versus value stocks.

To rebalance, you might sell assets in the over-represented categories and use the proceeds to buy under-represented assets. But this can present a tax-cost problem if you're dealing with taxable assets, so another method is to put new money only into the under-represented categories until you return the portfolio to its original allocation.

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