



“Because different asset classes produce different returns, the relative weighting inevitably drifts over time. Rebalancing brings the portfolio into alignment with the original target weights of each asset class by selling the overweighted asset classes and buying the underweighted asset classes. Through this discipline, the portfolio maintains the original risk profile intended for the client. **The process not only forces the investor to sell high and buy low, but it also reduces long-term portfolio volatility.**”

Rebalancing does have some potential disadvantages. For taxable investors, rebalancing may create additional taxes and transactions costs. There are concerns that long term portfolio returns may be reduced because investors are selling their winners. The discipline required by rebalancing creates extra work for both the investor and the advisor, as they must regularly value the various asset classes in the portfolio, analyze the extent of drift and ensure correct implementation. Finally, this discipline is counter-intuitive to characteristics of human nature documented in the literatures of behavioral finance.

“...The [worst] annual return on the two portfolios during this 23-year period [from 1980 – 2002] is dramatically different, [a loss of] 8.3 percent (after-tax) on the always-rebalanced portfolio compared to [a loss of] 12.0 percent (after-tax) on the never-rebalanced version.

Rebalancing does not necessarily generate improved return in a sustained bull market as it requires selling equities while they are going up. It is more powerful in volatile markets.<sup>5</sup> Nevertheless, rebalancing in a bull market reduces risk. This helps clients achieve both the risk and the return requirements of their investment policy.

“...**Rebalancing prevents the portfolio from drifting to higher risk levels than intended by the investment policy.** A portfolio of 60-percent equity and 40-percent fixed income that was never rebalanced from 1980 to 2002 quickly became overweighted in equity and remained so for almost the entire time period. By contrast, rebalancing lowered risk and improved risk-adjusted performance as measured by the Sharpe Ratio. In volatile markets, rebalancing actually increased returns. During the three longest and worst bear markets prior to 1980, the rebalanced portfolio clearly outperformed.”

**The Importance of Portfolio Rebalancing in Volatile Markets,**  
Steven B. Weinstein, Cindy Sin-Yi Tsai, Jason M. Laurie;  
*Journal of Retirement Planning*, July- August, 2003

### How often should you rebalance ?

While you should review your relative allocations at least annually, rebalancing should be based on the degree of drift from your target allocations, not time alone.

Some degree of rebalancing can occur each time new money is invested, without needing to sell an existing position. So, rather than rebalancing every year, adjust your changing allocations with new money first and only sell a high performing asset class when it is five percentage points above (or purchase when below) the desired portfolio weighting.