

Allocate, Rebalance, Reduce! A Primer for a Profitable Portfolio

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The stock market often takes investors on a wild ride. As such, it is a good idea to be reminded of three basic principles in investing. Asset allocation, rebalancing and lowering costs. Using these timeless principles to guide investment decisions will keep your portfolio on track and enhance returns over the long haul.

Asset Allocation

Set goals! It is important to have a plan. It keeps investors focused, encourages more saving and guides investors to make better decisions. Part of that goal is to set an asset allocation. An asset allocation is the amount of the overall nest egg held in each of the different asset classes. For most investors this means stocks, bonds and cash. Start with how much will be invested in the stock market. This should be determined by looking at ones risk tolerance, age, overall wealth, cash flow needs and the timing of those needs. A balanced account, which is considered conservative, would be 50/50. 50% of the nest egg is held in stocks and 50% in bonds and cash. A young person just starting out may have a 100% allocation to stocks because they have many years of savings ahead of them and have a long term horizon in the markets. Most investors seem to fall somewhere in between in the 60%-80% range.

After establishing an asset allocation target, build a diversified portfolio. On a broad scale, diversify stock holdings with bonds and some cash. Within those categories include some international exposure. Diversify stocks across industry sectors. Depending on the size of the portfolio, individual stocks and bonds are best to keep costs down and afford the most flexibility and control. For smaller investors, indexed mutual funds may be more appropriate. Understand that asset classes will react differently to market news and often move in the opposite direction. If truly diversified, it is likely that there will always be a sector among the holdings that will be out of favor. Modest losses are to be expected in any portfolio, but significant losses can take up to years to recoup. For this reason limit exposure to any individual security to 2% of the portfolio.

Time is your biggest ally. Start saving as early as possible. Review the plan and goals annually and only make changes to the allocation if life circumstances change. Don't fall into the trap of shifting the allocation due to market sentiment.

Rebalance regularly

To rebalance investments buy and or sell securities in the portfolio in order to reset the allocation back to the intended target. A portfolio that is created to meet a specific allocation to stocks, bonds and cash will not stay at those levels indefinitely. Movement in the market will shift these percentages over time. For example say an investor purchases 60% of stock A and 40% of bond B when establishing an investment portfolio. Over a year's time, stock A does really well and bond B stays about the same. At the end of the year, stock A may have risen to say 70% of the portfolio and bond B now makes up 30%. The market's return has caused the allocation to shift. This leaves the investor with more risk than originally intended. If not rebalanced, the risk stays higher as now there is a 70% exposure to future swings in the equity market when the intended goal was only 60%.

To rebalance, sell some of stock A and buy more of bond B so that the stock allocation is brought back to the intended 60%. This practice promotes a disciplined approach and forces an investor to sell at the highs and buy at the lows. Following this guideline will prevent emotional mistakes in times of market turmoil.

Rebalancing requires discipline. It is not easy to sell the winners and add to sectors or securities that are out of favor, but it is how you increase the chances of generating a higher return. Buying out of favor means you are more likely to be buying at the lows. Alternatively, chasing past performers is not a profitable strategy. The future is uncertain and will most likely contain some surprises as it plays out. Rebalancing guides an investor to stay focused long term and not lose sight of goals. Over time, through numerous market cycles, a rebalanced portfolio should outperform with less risk.

Reduce Costs

Market fluctuations cannot be controlled, but the cost of maintaining investments can be. Keep these costs down by reducing taxes and minimizing fees. Taxes are unavoidable; however, there are strategies to reduce the taxes on an investment portfolio. Hold investments for more than a year and take advantage of lower capital gains rates on stocks by holding the majority of equities in taxable accounts. Interest payments on taxable bonds are taxed at ordinary income rates so best to concentrate these holdings in tax-sheltered accounts such as an IRA. Look to add municipal bonds to a taxable account to

reduce taxes paid on bond interest. When rebalancing in a taxable account, an investor may need to sell stock because the overall stock portfolio has outperformed and stocks have increased over the targeted allocation. Yet within the portfolio, there are likely stocks that are at a loss. Choose to sell those stocks first to avoid triggering capital gains. Any losses realized can also be harvested and used to offset any future gains that may be generated in the portfolio. Carefully monitor the realized gains and losses throughout the year and potentially place some trades toward year end to generate losses if needed.

Fees can chip away at your returns over time. Manage transactions costs by limiting excessive trading. Use index funds to supplement your stock holdings as a source of liquidity. High costs on mutual funds can greatly impact your overall returns and research even suggests that lower-cost investments have tended to outperform higher cost alternatives. To evaluate performance accurately, make sure to look at net returns.

These are three commonly known principles that are easily ignored. Get back to basics, reduce risk and boost overall returns.