Did You Set and Forget?

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It's a new year, a great time to make sure your nest egg is still on track. Readjusting investments periodically is an important step in keeping a portfolio aligned with financial goals. Rebalancing to a pre-determined asset allocation will keep your risk profile in check, potentially enhance returns and can also prevent an investor from making impulsive decisions during times of market volatility. Typically, a rebalance involves selling one asset class and shifting funds to another asset class in order to stay aligned with a set asset allocation. Unfortunately, although many investors take the time to develop a proper asset allocation, they tend to "set and forget" skipping the crucial rebalancing step. As markets move over time, the allocation to stocks, bonds and cash will gradually shift. For example, you may be targeting a 70% allocation to stocks but not realize that it has slipped to 65% due to recent market underperformance. The tendency is to do nothing in times of volatility, but a regular rebalance would have you buy stocks to bring the allocation back up to target. It is not as important when you rebalance; just that you do it, and do it on a consistent basis. Year-end is a good time because it coincides nicely with other tax planning strategies.

Before moving to rebalancing, the first step is to set an asset allocation among stocks, fixed income and cash. Based on risk appetite and financial goals, set an allocation that will allow for sufficient growth, yet reduce portfolio risk and volatility. Selecting a diversified mix of investments when structuring a portfolio is also important. Diversification serves to reduce the overall impact of a volatile move in any one asset class. Setting a clearly defined asset allocation establishes a framework to rebalance regularly.

A set rebalancing schedule, whether it be annually, quarterly or monthly, takes the emotion out of investment decisions. It provides discipline and helps investors to make the right decision when markets are volatile. In a bull market, stock holdings increase in value and become a larger part of the overall nest egg, potentially leaving more risk than intended. A disciplined approach will force investors to sell holdings with big gains in likely expensive sectors, and invest in laggards and thus less expensive sectors. A rebalanced portfolio will reduce exposure to over weighted sectors, and be set up for greater returns when markets turn. Over time, through numerous market cycles, a rebalanced portfolio should outperform with less risk.

Transaction fees and tax consequences need to be considered as part of your rebalancing program. Unless there is cash in the account to invest, or you are making a planned withdrawal, reallocation will mean selling assets that have performed well. In a taxable account this may trigger taxable gains. There will also be transaction costs as a result of the trading. These costs are sometimes inevitable, but there are ways to avoid or at least minimize the impact.

To reduce transaction costs, be opportunistic. Direct systematic deposits and withdrawals to the asset class that is under or over weight. For example, if you have to take a minimum required distribution (MRD) from an IRA, take from the asset class, whether it be stocks or bonds, that is over its targeted allocation. If you make a regular monthly deposit into an investment account, invest it in the asset class that is below target. Cash is being invested so there is no need to sell anything that would add extra fees or generate taxable gains. If these deposits and withdrawals are made without regard to asset allocation at the time, you may create the need for excess trading and thus extra transaction costs as you attempt to rebalance at a later time. Rebalancing coincides nicely with year-end tax planning. As you look for potential sale candidates in the portfolio to offset tax gains, a rebalance can be done at the same time. Opportunistically investing will help keep the allocation in line and save on fees by reducing the need for additional trading.

To reduce tax costs, look for securities with a long versus a short term gain when selecting positions to sell. The tax rate is lower on securities that have been held for greater than one year. Also try to pair winning positions with losers. Realized losses will offset realized gains dollar for dollar.

Another important element to reducing tax costs is choosing the right account from which to sell and buy assets. There may be times when realizing a gain cannot be avoided, but first look to sell in tax sheltered accounts where you don't pay taxes on those gains. When adding fixed income, do so first in a tax sheltered account. As a rule, when structuring the accounts and when rebalancing, try to focus the equity in taxable accounts and the fixed income in tax advantaged accounts. Equity securities have preferential tax rates on long term capital gains and dividends that can only be taken advantage of in a taxable account. Bond interest on a fixed income portfolio is taxed as ordinary income, at your highest rate, so these assets are best held in a tax sheltered account.

A 401k is a good place to hold your generic fixed income securities because typically there are limited investment selections in these accounts. There is often a low cost bond index fund available that works well. As a result, 401ks and IRAs will be heavy in fixed income and as such will lag in an equity bull

market. This highlights the importance of looking at the portfolio's return as a whole in order to measure true performance. Unless you have a very high allocation to stocks or a very small tax sheltered account relative to your taxable account, it is likely that some fixed income will need to be held in your taxable account. In this case, look for tax exempt municipal bonds. If buying mutual funds in a taxable account, opt for index funds because they carry lower fees and trade less frequently and therefore are less likely to generate unexpected capital gains.

Setting a schedule at specific intervals throughout the year is one method to rebalance. Another option is to use percentage movements. For example if the equity portion of your investments are set at 65%, then whenever the allocation moves 5% above or below that target, that would prompt the investor to rebalance. How often and when to rebalance is based on individual circumstances and the size of the transaction costs relative to the proposed trades. The timing is not as critical as simply making sure to do it regularly.