PRIVATE ASSET MANAGEMENT, INC.
WEALTH STRATEGY ADVISORS

PARADIGM

June 2019

Last month, we reviewed the staying power of the 60/40 portfolio and the 4% rule. This month, we want to review another concept that has exhibited staying power as well: portfolio rebalancing.

Rebalancing portfolios involves the periodic buying and selling of assets to maintain the portfolio's desired asset allocation.

We will highlight several reasons behind the need to rebalance. Then we will review how your unique situation may make rebalancing easier or harder. The main takeaways from this *Paradigm* are to remain focused on your long-term goals while executing your shorter-term strategy.

Reasons to rebalance

Rebalancing forces you to focus on your long-term goals. You put much effort into defining your goals, desires and risk tolerance. Your portfolio reflects those decisions. It does not make sense to put those goals at risk just because stocks went up or down over the past 3-6 months. Rebalancing, therefore, helps you in remembering to focus on goals and not markets.

Rebalancing helps to control risk. When markets are going up, investors are happy. Inadvertently, though, they are taking on more risk the higher markets go if they don't rebalance. For example, an investor whose goals and risk tolerance mandate a portfolio 60% in stocks, could be 65% in stocks after a strong market. If that person chooses not to rebalance, that person is implicitly increasing their risk as markets move higher. The same is true in reverse; the unwillingness to buy stocks after a market decline may mean you are inadvertently decreasing risk as markets decline. In both cases, a slight rebalancing would help control your risk level.

Rebalancing may improve performance. We have read studies that show rebalancing can improve performance by 0.25% or more. However, consistency is key. Those that chose not to rebalance in early 2009 because they would not buy stocks greatly diminished the benefits earned from rebalancing over the past ten years.

Rebalancing a portfolio helps to maintain proper diversification, a central concept for successful long-term investing. Most of the time this process is fairly easy. At other times, especially when one asset is performing well and others are performing mediocre to poor, maintaining this discipline is difficult. Remember, no one asset is the best performer year in and year out.

Finally, rebalancing can keep overconfidence, a potential source of poor choices, in check. Overconfidence led to investors owning too many technology stocks in 2000, and to being too infatuated with commodities several years ago. Rebalancing imposes discipline on such behavior. This is useful because the vast majority of investors do not have the time or knowledge to be successful over a 10 to 20 year period with picks that probably have more to do with overconfidence than knowledge.

The ease of rebalancing

The ease in committing to the process of rebalancing can vary by investor. Here are a few examples.

People whose main source of money for living is their portfolio may find the process the easiest to commit to and to execute. Their goals may be clearer and, most likely, they consistently review their goals. Also, from poor past individual stock picks to trends that didn't end well, overconfidence is either gone or greatly diminished. Finally, in a year like 2008, they had first hand experience of the benefits of diversification with portfolios that declined roughly 20% versus a nearly 40% decline for an all stock portfolio.

Those close to retirement or those who 'need' a certain return in order to remain on track to retire may find the process tougher. For some of these investors, the benefits of diversification, especially if one asset is performing well above other assets, can be lost. Also, with interest rates as low as they now are, they may wonder about the need to own any bonds. Finally, the need to rebalance fades if performance is currently being helped by either overconfidence or not rebalancing. For these investors, we stress the need to review their goals and to make sure their portfolio is in sync with those goals.

Rebalancing may seem mundane or counterproductive. However, the process can be exceedingly useful for long-term success and should not be ignored.

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