



# **Is Now the Time to**

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# **REBALANCE**

# **Your Portfolio?**

by Alexander J. Cudzewicz

*A cornerstone of traditional financial planning wisdom is portfolio diversification. The theory behind diversification is that a portfolio that is invested in different kinds of securities or asset classes will, on average, have higher returns and lower risk than any single investment in the portfolio. A portfolio that includes not only stocks, but also bonds and cash, produces higher risk-adjusted returns over time. The asset allocation of many institutional pension funds and endowments cluster around a 60 percent equity, 30 percent bond, and 10 percent cash asset allocation.*

*Over time a portfolio's actual allocation to various securities or asset classes tends to drift as its investments do not appreciate or depreciate in lockstep or to the same degree. In a raging bull market, a portfolio with an initial allocation of 60/30/10 percent, may find itself holding 75 percent in stocks, 20 percent in bonds and five percent in cash. The solution is to*



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periodically rebalance the portfolio to bring it back to target. In this example, that would mean selling stocks, buying bonds and increasing the cash allocation.

In the February 2009 issue of *Financial Planning* magazine, Craig L. Israelsen, Ph.D., an associate professor at Brigham Young University, reports on a study of a seven asset class portfolio from January 1970 to October 2008. His analysis studied an equally weighted seven asset class portfolio comprised of large-cap U.S. equities, small-cap U.S. equities, non-U.S. equities, U.S. intermediate-term bonds, cash, real estate, and commodities. Details of this portfolio can be found at [www.7twelveportfolio.com](http://www.7twelveportfolio.com).

His study compared the differences between two portfolios, one which was rebalanced annually and the other where no changes were made (Buy-and-Hold). He assumed an initial investment of \$10,000. At the end of the study period, the Buy-and-Hold portfolio had grown to \$364,835. The annually rebalanced portfolio grew to \$468,929, an ending value 28.5 percent higher. Looking at rolling 20-year periods, the annually rebalanced portfolio generated superior performance in 14 out of 20 periods. The advantages of rebalancing documented in Israelsen's article are fairly typical.

In terms of frequency, most studies come down on the side of annual rebalancing. Part of the reason is practical. There are trading costs involved in buying and selling securities or mutual funds. The cost of too frequent trading undercuts the performance of a rebal-

anced portfolio. On the other hand, in fast-moving markets, rebalancing less than once a year can substantially increase a portfolio's risk. Annual rebalancing seemed to be a good compromise.

In 2005, there was a study by Gobind Daryanani CFP, Ph.D., which became the basis for iRebal software, and the company by the same name. His research used five asset classes: large-cap U.S. equities, small-cap U.S. equities, REITS, commodities and government bonds. He covered a variety of time periods from 1994 to 2004. His conclusion was that a tolerance band of 20 percent was optimal. For example, if you had allocated 50 percent to U.S. large-cap stocks and your allocation to them increased above 60 percent (plus 20 percent) or decreased below 40 percent (minus 20 percent), you should rebalance. He recommends reviewing your portfolio's allocation frequently. But his 20 percent tolerance band would lead to only about three trades a year, and add 0.38 percent to 0.39 percent of return a year—versus 0.20 percent for semi-annual or annual rebalancing.

But these studies and approaches were pre-September 2008. There has been a radical change in the investment landscape since then. U.S. household net worth fell by \$11 trillion in 2008. That's the largest decline since the Federal Reserve started keeping track of this data after World War II. It is the first time since the 1930s that both home prices and financial assets have decreased dramatically—together. Furthermore, nearly all assets have dropped

together. Portfolio diversification hasn't worked in this environment.

In April, the International Monetary Fund predicted that the global economy will shrink by 1.3 percent in 2009. If that occurs, it would be the first annual contraction of the world economy in 60 years. The U.S. economy is experiencing its worst recession since the Great Depression. It is expected to decline 2.8 percent in 2009, and remain flat in 2010. Unemployment in the U.S. was at 8.6 percent in April and is projected to rise to 10.1 percent in 2010. There are some economists predicting unemployment reaching 11 to 12 percent in 2011. The stock market may have shown recent signs of recovery, but for workers there is a lot more pain in the forecasts.

Since World War II, the world has always looked to U.S. consumers to lead the economy out of a recession. That is not happening this time. They are increasing their savings and paying down debts. Banks and other financial institutions are going through a massive deleveraging process, producing global price deflation. No one is predicting a return to the unbridled leveraging and high-risk appetite we experienced earlier in this decade. The expectation is that we are in a prolonged period of relatively poor economic growth.

Still, many advisors are advocating rebalancing a portfolio at this time. While admitting that markets could go lower, the 50 percent-plus drop leads many to see an historic opportunity to rebalance. Dave Kansas wrote an article in the January 25, 2009 *Wall Street Journal* entitled "Now's the Time to Rebalance Your Portfolio." In the Feb. 18, 2009 issue, Brett Arends wrote an article "Don't Bail Out of the Market. Re-Balance." But in a March 7, 2009 article by Jason Zweig entitled "Rebalancing Your Portfolio Can Be a Tough Ride" he admits "Rebalancing ensures that you buy low and sell high. It can work. But that doesn't mean it always works." And in an April 6, 2009 article by Shefali Anand entitled "Off Balance" the author notes, "But after the market caved last autumn, advisers felt that, by

adding stocks, they would be catching a falling knife, as the Wall Street saying goes.”

However, even some advisors that are not advocating rebalancing a portfolio at this time are finding an investment opportunity. There is no question that stock market prices have become more attractive over the last year. Large-cap stocks are selling at prices that are two to three standard deviations below their long-term trends. But as cheap as stocks may be, investment grade corporate bonds have become even cheaper. Last fall’s credit crunch has driven valuations of these bonds six to seven times below their standard deviations.

On a relative basis, investment grade corporate bonds have a higher upside potential as the economy improves. And, if the recession gets worse or persists, they have less downside risk than stocks. So some advisors are choosing to keep higher levels of cash and bonds in clients’ portfolios than they would under more normal market conditions. They are taking advantage of the current opportunity in investment grade corporate bonds with their higher yields and potential capital appreciation.

Regardless of what happened in 2008 and what may happen in the near future, the prevailing sentiment is that asset allocation does work and periodic rebalancing should increase a client’s return in the long term.

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