The Importance of Rebalancing your Investment Portfolio

Assuming your investment portfolio is doing well, it may be tempting to skip a portfolio rebalance at your next review meeting with your financial advisor. However, there are sound reasons why it could be a mistake to overlook this important aspect of investment management.

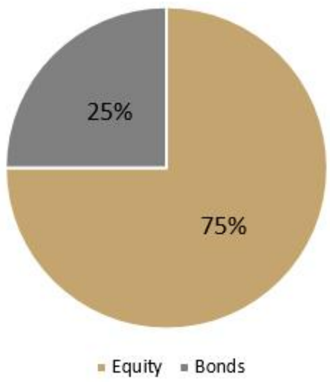
There are two fundamental reasons why a diversified investment portfolio should be rebalanced regularly. Rebalancing ensures that your portfolio is aligned with your own risk profile and secondly, the discipline involved enables an investor to stay on track with their financial plan, rather than being swayed by the 'noise' in the market.

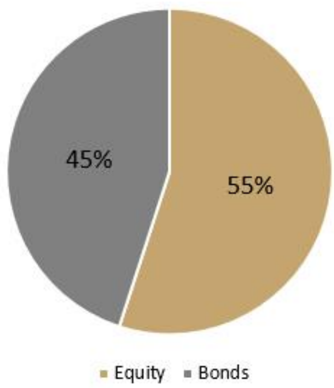
Rebalancing your portfolio ensures that your target asset allocation and consequently your portfolio's risk characteristics remain in line with your personal risk profile

A diversified portfolio should be made up of different asset classes in proportions actuarily calculated to achieve certain desired investment outcomes while taking a calculated amount of risk.

All investors, whether you are just starting out with small regular contributions to a retirement provision or are an experienced investor with a larger portfolio, should be familiar with the risk profiling exercise undertaken by your financial advisor and you should understand the principles of risk profiling.

An investor with a moderate risk profile (CPI +3%) would typically be invested in a portfolio with a split of 55% equities and 45% bonds and cash. If, hypothetically speaking, after a very good year or two on the stock market, the equity portion of your portfolio rises to 75%, the portfolio as a whole will have shifted into the **high risk** category.





Now that you have more equities in your portfolio, you're exposed to much more risk than you had planned to be. In order to address this, portfolios should be regularly rebalanced.

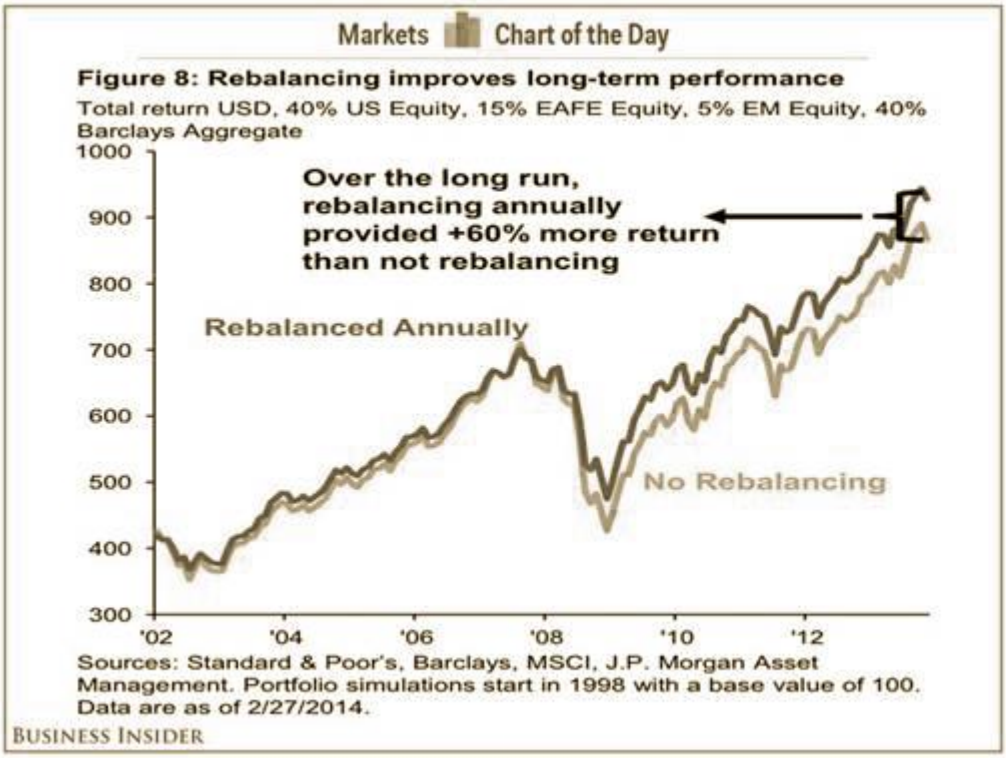
Balancing Risk and Reward

Asset allocation is all about balancing risk and reward. Inevitably some asset classes will perform better than others during a particular market cycle. As we have seen above, this can cause your portfolio to be skewed towards an allocation that takes on either too much or too little risk according to your financial objectives as defined in your risk profile. To rebalance from a high risk position to a moderate risk, we would need to sell some equities and buy some bonds. This means that we are selling the asset class that has performed better (selling high) and buying the asset class that is lagging in this cycle (buying low).

One of the great things about rebalancing is that it forces you to buy low and sell high.

The intrinsic discipline that comes with rebalancing your portfolio helps save investors from their worst instincts. It can be very tempting to hold on to top performing assets when markets seem to keep on going up, but market cycles obviously do also have down turns. So, by rebalancing, selling high and buying low becomes automated. Regular portfolio rebalancing also provides the investor with a measure of protection from the fall out of market crashes by ensuring that only the agreed upon portion of funds is at risk in equity markets.

Leading fund managers advocate rebalancing a diversified portfolio at least annually as part of a disciplined investment approach that avoids market bias. Their chart below, compiled by JP Morgan Asset Management, clearly demonstrates the value of an annual rebalance. Their research shows that over time the rebalanced fund provided 60% higher returns than a similar fund with no rebalancing.



Over the long term, rebalancing helped shield investors from being over and under exposed during market turmoil and rallies. The 60% difference results from a disciplined approach of buying low and selling high.

This reinforces the benefit of investing in Rutherford's funds as they are actively rebalanced on a continuous basis.