WEALTH MANAGEMENT

The Benefits of Rebalancing Portfolios

By Sandi Weaver, CPA, CFP, CFA

Many advisers have been doing quite a bit of rebalancing these last few months. CPA financial planners do that when a certain asset class or segment of the portfolio gets over the target allocation. Some investors protest against selling a "winning hand" only to invest in losers. Yet reversion to the mean is a known market behavior. Rebalancing can be viewed as selling investments that are at a (too) healthy price to buy other sound investments at a discount.

Advisers have various approaches to monitoring asset allocations in portfolios. One approach is to check asset allocations on the portfolios two ways each month: top-down and bottom-up. Does the client's portfolio across all their accounts, the top-down view, have the right amount invested in the lower risk asset classes? Lower risk asset classes are considered cash and equivalents, and fixed income bonds. These investments almost always have lower standard deviations around price action; i.e., their market values are steadier.

If the percentage of investments in cash and bonds is within a specific percent, say 5 percent, of the target allocation, risk is within range. If it's outside of that margin, the adviser looks hard at taking action now unless an upcoming known event will correct that. For example, a planned deposit or contribution by the client would need to be invested, and the imbalance can be corrected with that. Or the allocation can be resynced if there's a need to raise cash soon for upcoming withdrawals. But if no event is planned, the adviser may rebalance, sell investments that have risen in value to reinvest in others which have not. It's important that the client's portfolio risk level doesn't stay elevated too long.

In bottom-up monitoring, each asset segment is checked to see if it's within its target, say a 3 percent or a 5 percent range, in each account of the client's portfolio. If not, the adviser considers whether to rebalance now or wait. Knowledge of current economics and corporate earnings tempers the urge to trade and realign immediately. Often out-of-target positions exist only for a month or two, and correct quickly. Yet an imbalance that persists warrants action.

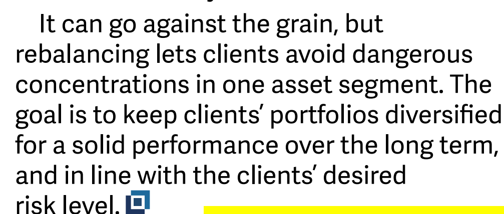
Interplay among asset segments can matter. If a client's portfolio is over-target in one international asset segment, and over-target in another international segment, that's cause to take action more quickly. Software helps automate much of this process, but advisers always want more sophisticated parameters in the software!

Rebalancing lets a client sell an investment that's hitting on all cylinders and is perhaps becoming overblown. The market—whether stock prices or bond interest rates—tends to build momentum, get carried away, and correct to a more rational basis. It runs similarly on the downside during corrections or bear markets.

Rebalancing can also trim back an investment at a healthy price. There's no need to try to pick the absolute high. Rebalancing by nature can shift the focus to other core investments that may be out of favor yet are still viable, profitable companies.

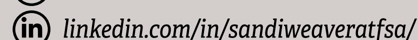
In many portfolios advisers have recently been trimming large U.S. growth companies. Think the "magnificent 7:" Nvidia, Microsoft, Alphabet, Meta, Amazon, Tesla, Apple. Their prices are elevated at over 30 times future earnings, which are expected to be robust due to artificial intelligence. The rest of the market trades around 20 times earnings. Selling just a bit of those, while keeping a substantial position there, redeploys that cash into investments running a bit cheap. What's cheap? Bonds may be, especially if the Federal Reserve reduces interest rates later this year or next. Overseas stocks are cheaper than their U.S. cousins right now; some analysts have been advocating solid companies there. A rebalanced portfolio is still in position to benefit if large growth companies exceed the earnings priced into their shares today.

It can go against the grain, but rebalancing lets clients avoid dangerous concentrations in one asset segment. The goal is to keep clients' portfolios diversified for a solid performance over the long term, and in line with the clients' desired risk level.



Sandi Weaver is the owner of Weaver Financial in Mission, Kan.

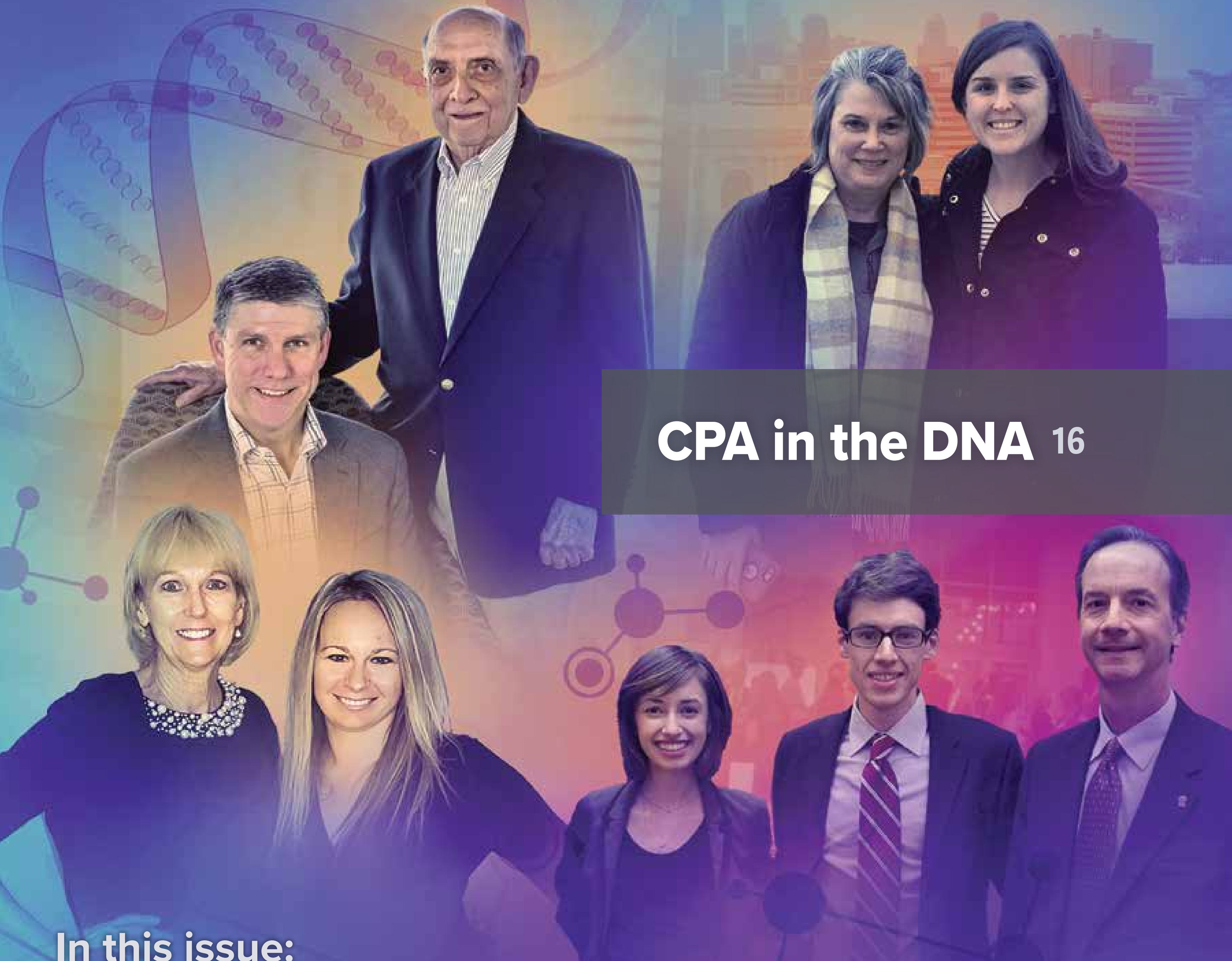
Sandi@WeaverFinancialPlanning.com


linkedin.com/in/sandiweaveratfsa/

May—June 2024

THE ASSET

Official Publication of the Missouri Society of Certified Public Accountants



CPA in the DNA 16

In this issue:

CPA Evolution Unleashed: Transforming Missouri's Accounting Education Programs 8

Top 10 Reasons Today is the Best Day Ever to be a Young CPA 12

Generative Artificial Intelligence Solutions: Understand Your Risks 14