Decipher Your Investment Puzzle

When you set up your investment portfolio, you probably also settled on an asset allocation strategy — for instance, 60% stocks and 40% bonds. You, perhaps with the help of your Financial Advisor, determined that this particular balance of investments could help you generate average returns that would help you meet your financial goals and match your personal tolerance for risk.

As the economic market shifts, though, everyone's financial portfolio naturally drifts out of balance to some degree, says Tracie McMillion, CFA®, Investment Research Manager, and Head of Asset Allocation for the Wells Fargo Investment Institute. During a market downturn, for example, the stock allocation of your portfolio could shift from the 60% you originally envisioned to just 50% because the value of those stocks decreased while the value of the bonds remained steady. To get your portfolio back to its original allocation, you might need to sell some bonds and buy additional stocks at their current, lower prices.

The importance and timing of rebalancing
This practice, known as "rebalancing," is a critical part of maintaining a healthy financial portfolio. "Rebalancing is intended to both control the risk in your portfolio and help potentially enhance your returns over time," she says. It's not, however — as some people believe — a way to try to maximize your portfolio's earnings, notes McMillion. "It's simply meant to take your investments back to that original, well-balanced asset allocation you, with the help of your Financial Advisor, determined was correct for you," she says.

So how do you know your portfolio needs a refresh? There are two primary "trigger strategies" for rebalancing your investment portfolio, explains McMillion. The first is time: You regularly rebalance your portfolio on a specific schedule — quarterly or annually, for instance. The second is threshold: You routinely readjust your investment mix when your allocation is out of balance by a particular amount — such as 5%. It's also possible to use a combination of the two strategies.

Choose a strategy
McMillion believes that no single approach — time, threshold, or a combination — is significantly more effective than another. What's most important is to pick a consistent rebalancing strategy and stick with it. Work with your Financial Advisor to choose a regular rebalancing structure that meets your needs.

Some factors to consider when selecting your personal rebalancing approach:

- **Taxes.** Buying and selling investments in most nonretirement investment accounts can trigger capital gains taxes. So if you're rebalancing in a taxable account, particularly if you're in a higher marginal tax bracket, you may want to consider rebalancing your investments less often — annually, instead of quarterly, in October or November — suggests McMillion. That gives you time to plan for what you may owe the IRS the following April.

Depending on your tax situation and your income needs, you'll need a good mix of assets to adequately rebalance and often, income-producing assets are more tax efficiently held in tax advantaged accounts.

- **Trading fees.** These costs may complicate the decision to rebalance, since buy/sell actions could result in extra charges. McMillion suggests checking with your Financial Advisor to make sure your investment vehicles don't charge onerous transaction fees or have strict trading restrictions. It's also important to consider regulatory limitations for certain securities (for example, mutual funds) may have limitations on purchases and redemptions.

- **Emotions.** "Regardless of what you initially decide, it can be really challenging to sell some of your 'winning' investments and buy 'bargains' during rebalancing," says McMillion. However, this tactic can be important if you want to take advantage of the financial market's best prices. "Buying low and selling high should always be a core strategy," McMillion reminds.

Get it in writing

One way to stick to your strategy and make sure it's not just a one-time rebalancing attempt is to put your asset allocation plan in writing and discuss it with your Financial Advisor. Once you've developed the strategy, many advisors with discretionary authority will do the actual rebalancing on your behalf according to your agreed schedule or guidelines.

Having a set schedule is a great start, but McMillion notes there are a couple of situations in which you may want to rebalance even if it's not your normal time to do so:

- **There's been a significant market change — positive or negative.** Although you don't want to let typical market ups and downs trigger you to rebalance early, a major correction could throw your portfolio significantly out of balance, says McMillion. In that case, you may want to talk with your Financial Advisor about making some portfolio adjustments early, rather than waiting for a predetermined date.

- **You've had a major life change.** If something significant occurs that could fundamentally shift your financial goals — the birth of a child, job change, divorce, remarriage, or significant health challenge — you may want to revisit your portfolio allocation with your Financial Advisor to make sure it still meets your needs, suggests McMillion. That could warrant a new allocation strategy, not just a simple rebalancing. It's also important to remember that as you get closer to retirement, your allocation strategy may become more conservative to protect your portfolio for when you need to start using the money for living expenses.

Overall, McMillion says, keep in mind that creating a healthy asset allocation strategy should not be a "set it and forget it" activity.