

Rebalancing the Investment Portfolio

a basic need, not just an act

You have analyzed your financial situation, articulated your financial goals, developed an investment strategy, decided on asset allocations and selected the investments for your portfolio. So what's there to do besides monitor performance and make any additional contributions your plan calls for? Even apart from periodic re-examination of your situation and objectives, there is one important need. Financial assets, like other assets, require maintenance, and the primary maintenance requirement for any investment portfolio is rebalancing.

Rebalancing an investment portfolio means adjusting its contents to keep risk consistent with your objectives. In practice, the process requires matching the portfolio's assets to the allocation targets you set in your financial plan.

The need arises because financial markets and asset values are continually changing.

Some of the asset classes represented in your portfolio may grow; others, shrink. In time the

portfolio inevitably strays from your intended allocations, and so, from your strategy for managing risk... and opportunity.

Say your investment plan called for allocating 50 percent to domestic stocks, 30 percent to bonds, and 10 percent each to real estate and commodities (in index or other funds). Now, say commodities rise sharply over the course of a year and bond prices rise nicely, but domestic stock prices decline and real estate slides substantially. Your portfolio no longer matches your target allocations. (See graph.) Stocks and real estate are now smaller proportions of your investments than you intended, while bonds and commodities are slightly bigger proportions, changing the risk profile of your portfolio.

To rebalance the portfolio you sell some of the foreign stocks and commodities and add to domestic stocks and real estate, bringing the portfolio closer to its planned allocations. If you can rebalance by making the changes in the tax-sheltered part of your portfolio—

in an IRA or a 401(k) plan, for example—you'll avoid tax liabilities. Depending on the size of the imbalance, you may be able to rebalance simply by putting any regular contributions to the portfolio into an asset class that is underweight compared to your targets.

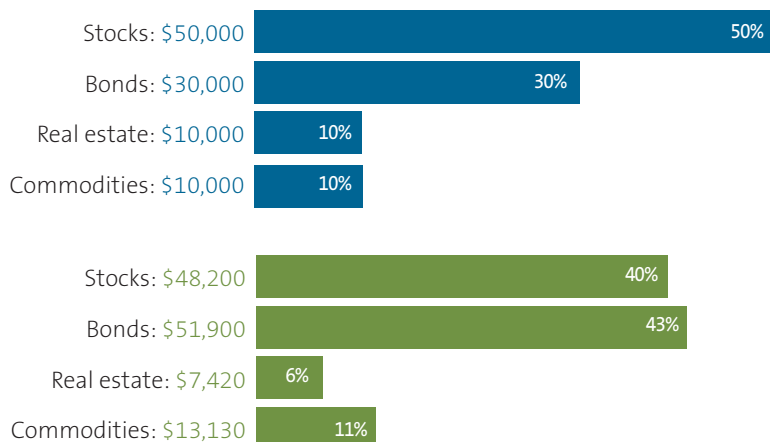
But why sell assets that have done well, you say? And why bolster the poor-performing component of your portfolio when those prices might go still lower? One reason is that trying to "time the market" is a notoriously poor strategy; nobody knows when a market will peak or bottom.

Market-caused Changes in Asset Allocation

Hypothetical \$100,000 investment portfolio*
12 months ended Feb. 29, 2008

■ March 2007

■ February 2008 (percentages rounded)



*Stocks, S&P 500 Index; bonds, Lehman Brothers Aggregate Bond Index; real estate, Dow Jones Wilshire REIT Index; commodities, Dow Jones-AIG Commodity Index



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continued

Sticking to your plan is much more likely to yield the best long-term results. Indeed, getting the best long-term results was the reason for the plan.

Rebalancing also makes performance sense even apart from planned allocation targets.

One basic investment strategy is rooted in the likelihood of “a return to the mean.” That is, in the long run, the performance of any asset class is likely to approximate its historical pattern. Highs in a particular investment category—such as intermediate-term Treasury bonds, small-

Rebalance when assets stray significantly from allocation targets.

cap growth stocks or large-cap European stocks—are eventually followed, according to this assessment, by lows that bring overall performance back into line with the historical norm. As a result, one of the simplest investment strategies—selling the winners and buying

the losers—has demonstrated merit. Rebalancing accomplishes just this. It takes gains in the asset categories that have recently prospered and reinvests them in those that have not. When the recent winners flag and the laggards pick up, the portfolio benefits.

How often should you rebalance your investment portfolio? Since asset prices—and so your actual asset allocations—fluctuate daily, trying to keep your portfolio matched to your target allocations over short periods of time merely churns investments and piles up transaction expenses. Every quarter, six months or year, then? Certainly one should compare one’s portfolio composition to targets at least this often. But it may be better to tie rebalancing to the size of the imbalance rather than to arbitrary time periods.

In this approach you might consider rebalancing when any major asset category in the portfolio has strayed from your target allocation by more than some percentage—say, 10 percent. If for example your plan calls for allocating 60 percent of your portfolio to stocks, consider rebalancing if stocks grow to 70 percent or diminish to 50 percent of the portfolio. In the case of small allocation targets, such as 5 or 10 percent allocated to real estate or commodities, you might want to rebalance in response to a change of just a few percent.

Regardless of the frequency or the criteria, rebalancing is a basic necessity for any investment portfolio aimed at managing risk for long-term performance—whether your primary objective is asset preservation, income generation or asset growth.

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