DOW THEORY FORECASTS®

How often should you rebalance?

By most measurements, 2013 was an excellent year for stock investors, with the S&P 500 Index delivering a total return of 32.4% and 94% of the index's components managing positive returns for the year. Nearly three-fourths of the stocks in the large-cap index returned more than 20%.

However, many investors have fallen victim to their own success and might need to rebalance portfolios. Stocks probably make up a larger portion of your portfolio relative to bonds than they did a year ago. And within your stock holdings, top performers account for a bigger piece of the pie, while those that lag have shrunk to lower weightings. To rebalance, you sell a portion of your winners and purchase the losers, reverting to a prior weighting.

For example: Suppose you'd started the year with your $100,000 portfolio divided between two exchange-traded funds, $50,000 in Vanguard S&P 500 *(VOO)* and another $50,000 in Vanguard Total Bond Market *(BND).* Assuming reinvestment of dividends, at the end of the year your portfolio would have grown to $115,000, with just over $66,000 in the stock fund and just under $49,000 in the bond fund, which lost 2% *including* dividends.

After stocks' strong performance, they'd make up 57.5% of the portfolio. To rebalance back to the 50/50 weighting, you'd sell enough of the stock fund to shrink the position to $57,500 and invest the proceeds in the bond fund.

By sticking with a higher stock allocation, in effect you're making a bet that stocks will once again outperform. However, according to Morningstar, long-term government bonds have topped the return of large-company stocks in 10 of the last 25 years. The *Forecasts* expects stocks to keep outperforming bonds over the next year, but we're not sufficiently confident to advise readers to alter their long-term asset allocation.

If you have targeted a certain mix of stocks, bonds, and other investments, rebalancing periodically should keep your portfolio's risk fairly steady over time. Of course, the key word is "periodically," because every time a stock makes a move, your portfolio deviates slightly from its target weightings. So how often should you rebalance your holdings?

Many academics and finance professionals have studied rebalancing, and while not every study yields the same results, we’ve identified two common trends:

• Frequent rebalancing (monthly or quarterly, or using tight tolerance bands) ramps up costs quickly because of the volume of transactions needed. Any outperformance caused by the rebalancing is often gobbled up by trading costs.

• The most effective rebalancing strategies are those that keep costs low and limit volatility. Rebalancing costs include brokerage commissions when you buy or sell and potential tax liability when you sell a security that has increased in value since you purchased it.

We have long advised readers to limit transaction costs by using a discount broker, but taxes are tougher to control. Assuming the transaction costs are reasonable, investors can afford to rebalance tax-protected accounts such as IRAs more often than taxable accounts. However, frequent rebalancing doesn’t seem to pay off for investors, even without taking taxes into account.