It's a Balancing Act

You've carefully weighed in your own mind how you want your retirement portfolio to look: just the right amount of your assets allocated to stocks versus fixed-income investments. You feel comfortable with the growth/income and risk profile of your portfolio, and you have carefully diversified your investments over all the investment categories, and even within each category. Then, inevitably, the market jumps up or down, and your portfolio is thrown completely off balance.

What should you do?

First, relax. Your asset allocation guidelines are just that—guidelines. Aim to hit your percentage asset allocation targets over the long run, but be prepared to accept short-run variations caused by normal market cycles that will affect large stocks, small stocks, international stocks, and bonds differently.

How much variation should you tolerate before you need to take action to rebalance your asset allocation?

There really is no precise answer. But when asset allocations are off 10% or more, the process of rebalancing should start.

As an example, let's say your broad asset allocation guidelines call for 70% invested in stocks and 30% invested in fixed income. If stock prices rise and cause your allocation to change to 80% in stocks and 20% in bonds, it's probably time to rebalance.

If your 80% stock investment remains well-diversified but it is simply too large a portion of your retirement portfolio, it makes sense to nudge the percentage back toward 70%. How should you accomplish this?

Your first choice should be to rebalance using your current periodic contributions. If your portfolio value is very large relative to your annual contributions, you may have to redirect as much as 100% of your contributions toward fixed income in order to rebalance. If redirecting your contributions won't result in a rebalanced portfolio over a year's time, then you may need to rebalance by transferring some portion of your stock holdings to your fixed income investments.

But there's another important benefit of rebalancing: It forces you to buy low and sell high. For example, suppose that your desired allocation to stocks is 70%. In a rising stock market, the increased value of the stocks in your portfolio could easily result in stocks amounting to 80% of your total portfolio. To rebalance your stock allocation back down to 70%, you would sell stock while the market is relatively high (selling high). Now, consider a falling stock market. If the stock market is trending down, the stock portion of your portfolio will fall below 70%. To rebalance back up to 70%, you will have to buy more stock, but you will be doing so when the market is relatively low (buying low).

Your retirement portfolio is a balancing act. Keep tabs on your allocations quarterly and start to rebalance when broad allocations deviate more than 10% from your guidelines.

Don't wait too long to regain your portfolio balance—the farther you lean in any direction, the harder it is to catch your balance.