Portfolio Rebalancing and the "Problem" With Bull Markets

By Maria Crawford Scott

Frank and Katherine Parker have a "problem." The strong bull market over the past few years has gored their asset allocation strategy. The Parkers live off of their retirement savings and try to rebalance their portfolio each year by withdrawing spending money from asset classes that have become a greater percentage than their desired allocation calls for. But the bull market in U.S. stocks has stampeded their withdrawals and thrown their rebalancing approach off balance—not a bad dilemma for investors to face, but a dilemma nonetheless.

What should they do?

Where They Started

The Parkers started out two years ago with a total savings portfolio of $450,000, including about $22,000 in a tax-deferred IRA account. The savings are used to supplement pension and Social Security payments, and they plan to withdraw roughly $20,000 a year, an amount they could increase by the rate of inflation if necessary and still remain financially secure for the rest of their lives.

The Parkers' desired asset allocation has 75% of their investment portfolio committed to stocks (50% in large-capitalization stocks, 10% in 10 individual holdings of small-company stocks, and 15% in international stocks), 15% in intermediate-term bonds, and 10% in cash. The cash portion is invested in a money market fund to provide liquidity for emergencies and to temper the volatility of the portfolio's value.

Although it may appear to be a heavy commitment to stocks for individuals living in retirement, it is not nearly as heavily committed when their pension and Social Security payments are taken into consideration.

Although the Parkers have only a small amount of their investment portfolio in tax-deferred accounts, they have invested it in their highest-returning investment—an aggressive growth fund—to get the most benefit out of tax-deferral. Their taxable accounts include an S&P 500 index fund, a large-cap equity income fund, individual stocks, and an intermediate-term bond fund to assure at least some steady income for their annual spending amount.

The Parkers reinvest the distributions from their tax-deferred fund. Distributions from their taxable funds are used as part of their annual spending amount and are automatically "swept" into their money market fund. Since distributions from their funds do not usually provide their full $20,000 spending amount, the Parkers make up the difference by selling shares from areas in their portfolio that are "overweighted," representing a greater percentage of their total portfolio than desired.

Rebalancing: Year 1

At the end of the first year, the strong market had already caused their portfolio to teeter off balance, as shown in Table 1. Before making any withdrawals from their portfolio, the Parkers had almost 80% of their portfolio in stocks, including 55% in large-cap stocks—roughly 5 percentage points off of their desired allocation. Their intermediate-term bond fund was unable to keep pace, with "only" a 15% return, and by the end of the year their allocation was off a little over a percentage point. Their commitment to international stocks was off even more—by 2½ percentage points, because of the dismal performance of their international fund; the Parkers were particularly disappointed here because they had expected international stocks to provide them with particularly high returns. And their cash commitment is now below 10%.

Assessing their situation, the Parkers first determined how much they needed to sell to raise their $20,000 spending amount. At the end of the first year, their total portfolio was

Maria Crawford Scott is editor of the AAII Journal.

Table 1.
Rebalancing: The Bull Market "Problem"

The Parkers: Year 1 Savings Portfolio

Holding	Type of Acct	Value as of Begin Year 1 ($)	Return Year 1 (%)	Distri butions (to MMF) ($)	Value as of End Year 1 ($)	Action Taken	Value After Transactions ($)
S&P 500 Index Fund	Taxable	180,000	37.5	4,320	243,180	sell $12,000	231,180
Equity-Income Fund	Taxable	45,000	30.1	1,710	56,835		56,835
Aggressive Growth Fund	IRA	22,500	34.3	0	30,218	None	30,218
Small Stock Holdings	Taxable	22,500	31.4	0	29,565	sell $1,395	28,170
International Fund	Taxable	67,500	1.2	1,147	67,163	None	67,163
Intermediate-Term Bond Fund	Taxable	67,500	15.2	5,850	71,910	None	71,910
Money Market Fund	Taxable	45,000	5.6	Reinvested	60,547	sell $6,605	53,942
	Total:	**450,000**		**Total:**	**559,418**	**Total:**	**539,418**
				Total Ex Spend Amt:	**539,418**		

Year 1 Asset Allocation

Asset Class	Starting Allocation (%)	Allocation as % of Total Excluding Spending Amount*: End Year 1 (%)	After Transactions (%)
Large-Cap Stocks	50	55.6	53.4
Small-Cap Stocks	10	11.1	10.8
International Stocks	15	12.5	12.5
Bonds	15	13.3	13.3
Cash	10	7.5	10.0
	100	100.0	100.0

** Value divided by Total Ex Spend Amount*

The Parkers: Year 2 Savings Portfolio

Holding	Type of Acct	Value as of End Year 1 ($)	Return Year 2 (%)	Distributions (to MMF) ($)	Value as of End Year 2 ($)	Action Contemplated	Value After Transactions ($)
S&P 500 Index Fund	Taxable	231,180	22.9	5,940	278,180	sell $8,403	269,777
Equity-Income Fund	Taxable	56,835	24.2	2,046	68,543		68,543
Aggressive Growth Fund	IRA	30,218	19.1	0	35,989		35,989
Small Stock Holdings	Taxable	28,170	26.8	0	35,720		35,720
International Fund	Taxable	67,163	0.5	1,188	66,311		66,311
Intermediate-Term Bond Fund	Taxable	71,910	5.2	6,502	69,147		69,147
Money Market Fund	Taxable	53,942	4.8	Reinvested	72,207	sell $11,597	60,610
	Total:	**539,418**		**Total:**	**626,097**	**Total:**	**606,097**
				Total Ex Spend Amt:	**606,097**		

Year 2 Asset Allocation

Asset Class	Desired Allocation (%)	Allocation as % of Total Excluding Spending Amount*: Starting Allocation (%)	End Year 2 (%)	After Contemplated Transactions (%)
Large-Cap Stocks	50	53.4	57.2	55.8
Small-Cap Stocks	10	10.8	11.8	11.8
International Stocks	15	12.5	10.9	10.9
Bonds	15	13.3	11.4	11.4
Cash	10	10.0	8.6	10.0
	100	100.0	100.0	100.0

** Value divided by Total Ex Spend Amount*

valued at $559,418. The Parkers want to maintain a cash allocation of 10% of their assets (excluding their spending amount), which means that they need to leave $53,942 in their money market fund [10% of ($559,418 – $20,000)]. Since their money market fund had $60,547 at the end of the year, they can withdraw $6,605 from their money market fund ($60,547 – $53,942) for spending; they would then need to sell $13,395 ($20,000 – $6,605) from their other funds to make up the difference for their annual spending amount.

The Parkers decided that the bulk of their sales should come from their most overweighted asset class—large-cap stocks, and so they sold $12,000 of shares from the S&P 500 index fund. In addition, they decided to sell some shares of one of their individual stock holdings that had done spectacularly well that year and was becoming a particularly large holding among the individual stock portfolio. However, the Parkers continued to believe that the stock would do well, so they did not sell the entire holding.

After the transactions, the Parkers' investment portfolio was only a few percentage points off balance, and the Parkers at this point decided not to bother with any other rebalancing transactions.

Year 2: The Bull Market Continues

The Parkers continued to enjoy strong returns from their U.S. stock funds during the second year. However, the Parkers were less than thrilled with their intermediate-term bond return of 5.2%, although that return is actually what they expected to receive over the long-term from that investment. And for a second year in a row, their international fund was a huge disappointment, with a return of less than 1%.

The bottom line: By the end of the second year, the Parkers' investment portfolio is more seriously out of whack.

While the minimalist approach worked the first year, it really won't work very well now (see "Year 2" in Table 1). Using the first-year approach, the Parkers determined that they would need to sell $8,403 of shares to make up the spending amount difference if they want to maintain a 10% commitment to cash in their money market fund. But selling shares from their most overweighted category, large-cap stocks, still leaves them 6 percentage points overcommitted to large caps, and undercommitted to both international and intermediate-term bonds (shown in Table 1 in the asset allocation column labeled After Contemplated Transactions).

To make matters worse, any serious rebalancing would result in taxable transactions. The Parkers could transfer their aggressive growth fund IRA to new IRAs invested in international and intermediate-term bonds, but there is not enough in the IRA to bring both the international and intermediate-term bond categories up to their desired level. In addition, it would not affect their largest overcommitment, to large-cap stocks.

As the Parkers pondered their situation, a number of conflicting thoughts run through their minds.

They are extremely disappointed with their international commitment. The fund itself has done well relative to its peers, so their concern is not with their particular holding. But the international stock category was an area that they considered to be "aggressive," and it was supposed to bring them higher returns. Should they reconsider their commitment?

On the other hand, they are worried about their commitment to domestic stocks, and particularly large caps. The market has been strong for several years now—surely that can't continue. Should they forget about their commitment to large caps and get out now before the inevitable correction?

On the third hand, and in conflict with the second hand, they are reluctant to sell any of their existing holdings that have done so well. Why not stick with the winners and dump the losers?

And on the fourth and last hand, it really irks them to pay more taxes than necessary.

Sticking With the Plan

The Parkers discuss the pros and cons of various actions and eventually decide that they really need to stick with their original asset allocation plan. After all, the strategy is designed to provide a course of action during times when the market's behavior may cause investors to make decisions based on emotions, decisions that are often not in their long-term best interests.

The Parkers will add to their international holding. While the markets have done poorly over the last few years, this may provide them with a buying opportunity now. They will also add to their intermediate-term bond holding to bring it up to their desired level. To the extent possible, they will do so by transferring assets from their aggressive growth fund IRA to new IRAs in these categories. Although this means that their highest-returning assets will no longer be in their tax-deferred account, it is outweighed by the benefit of rebalancing now at a lower tax cost.

The Parkers will remain invested in large-cap and small-cap domestic stocks—they have no idea when, or even if the "inevitable" market decline will occur, since it has been predicted now for the past several years. Instead, they will rely on their diversified allocation approach—investing across various parts of the stock market as well as in other asset classes, including cash for liquidity—to temper the volatility of their overall portfolio and allow them to weather the storm of a major market drop. In addition, selling these stocks would result in enormous tax consequences now.

Now, they come to the most difficult decision: They have decided that they will sell some of their shares in their large-cap funds to rebalance their portfolio, even though it means taxable distributions they don't need for

spending. However, they will bring their large-cap commitment to 52%—a few percentage points higher than their target—to keep the tax consequences as low as possible.

In addition, since the Parkers review their portfolio before the end of the tax year, they therefore are able to spread their sale over two tax years, which will prevent the sale from pushing them into a higher tax bracket.

Bull Market Rebalancing

Every silver lining has a cloud, to paraphrase a saying. No investor is going to complain about a major bull market—unless they've missed it. But bull markets can cause asset allocation strategies to stray far from their target levels.

Investors who are still working and adding to their investment portfolios can use those additions to keep the portfolio in balance. But this is more difficult to do when you are withdrawing from an investment portfolio. There is only so much that can be accomplished through selective withdrawals and buying or selling from tax-deferred accounts. At some point, you have to balance the risk of being overcommitted to one asset class—an asset class that has had a big run-up recently—versus paying taxes unnecessarily. This is a tough decision, and hard to quantify. Here are several things to keep in mind:

- Don't worry about straying from your desired allocation by a few percentage points, but straying by 5 percentage points should start to become a concern, and straying 10 percentage points will have a major impact on your overall portfolio's return. In between that range—it's a tough decision and will most likely be dictated by your personal tax situation and your personal preferences.
- In addition, you may want to take into consideration the size of your commitment to the asset class. At least 10% of a portfolio must be committed to a market segment to have a meaningful effect. If your desired allocation to a particular asset class is only 10%, you would not want to stray below that amount by very much; in contrast, falling a few percentage points below a 30% desired level would be less of a concern.
- Rebalancing helps you remain diversified, so that you are not overly dependent on one area of the market for your performance. Remember that when you are withdrawing assets, it is risky to have very volatile returns year to year. Diversification smooths out volatility.
- Rebalancing also provides a discipline in that it forces you to sell "high" and buy "low."
- If you do rebalance using taxable accounts, do so in a way that minimizes taxes.
- If you are managing a portfolio of individual stocks that has been very successful, consider selective pruning of individual holdings that have done well, so that your stock portfolio itself is balanced and not too heavily invested in one or two particular stocks.
- Remember that rebalancing does not need to be frequent—annually is sufficient. However, your actual portfolio allocations will be constantly changing due to varying performances and as you withdraw funds.
- Enjoy the bull market while it lasts, but don't let several terrific years deflect you from a long-term strategy.