

The Financial Navigator – June Newsletter

In this issue of the Financial Navigator we discuss two investment management techniques, portfolio rebalancing and Dollar-Cost-Averaging; the former can help to manage portfolio risk and returns, the latter may not. Please feel free to forward this newsletter to any individuals that you may think might be interested. If you don't want to receive future editions, please follow the link at the end of this email to safely unsubscribe, or email us at the above email address. Thank you for taking the time to view this email.

Sincerely,
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Rebalancing Act

Global diversification gives investors a valuable tool for managing risk and volatility in a portfolio. But smart diversification has an important side effect. It requires maintenance.

In a given period, asset classes experience divergent performance. This is inevitable and, in fact, desirable. A portfolio that holds assets that do not perform similarly will experience less overall volatility. That results in a smoother ride over time. However, as some assets appreciate in value and others lose value, your portfolio's allocation changes, which affects its risk and return qualities. If you let the allocation drift far enough away from your original target, you end up with a different portfolio.

Once you form a portfolio to match your current investment goals and risk tolerance, you should preserve its structural integrity since asset allocation accounts for most of a portfolio's return.¹ In other words you must manage asset drift.

Rebalancing is the remedy. To rebalance, you sell assets that have risen in value and buy more assets that have dropped in value. The purpose of rebalancing is to move a portfolio back to its original target allocation.

Why rebalance?

At first glance, rebalancing seems counter-productive. Why sell a portion of outperforming asset groups and acquire a larger share of underperforming ones? Intuition might suggest that selling previous winners may hinder returns in the future. This logic is flawed, however, since past performance may not continue in the future—and there's no reliable way to predict future returns.

Equally important, remember that you chose your original asset allocation to reflect your risk and return preferences. Rebalancing realigns your portfolio to these priorities by using structure, not recent performance, to drive investment decisions. Periodic rebalancing also encourages dispassionate decision making—an essential quality during times of market volatility. Moreover, if and when your overall financial goals or risk tolerance change, you have a foundation for making adjustments. In the absence of a plan, adjustments are a matter of guesswork.

Challenges and decision factors

In the real world, portfolio allocations are usually complex, incorporating not only fixed income and equity, but also the multiple asset groups within equity investing. The more complex a portfolio's allocation, the greater is the need for maintenance. Determining when and how to effectively rebalance requires careful monitoring of performance and awareness of your tax status, cash flow, financial goals, and risk tolerance. Rebalancing also incurs transaction fees and potential capital gains in taxable accounts. Thus, while there are good reasons to rebalance, the benefits must outweigh the costs.

Most experts recommend rebalancing when asset group weightings move outside a specified range of their target allocations. This may be widely defined according to stock-bond mix, or more appropriately, according to a percentage drift away from target weightings for categories like small cap stocks, international stocks, and the like.

While rebalancing costs are unavoidable, several strategies can help minimize the impact:

- Rebalance with new cash. Rather than selling over-weighted assets that have appreciated, use new cash to buy more under-weighted assets. This reduces transaction costs and the tax consequences of selling assets.
- Whenever possible, rebalance in the tax-deferred or tax-exempt accounts where capital gains are not realized.
- Incorporate tax management within taxable accounts, such as cost basis management, strategic loss harvesting, dividend management, gain/loss matching, and similar considerations.
- Implement an integrated portfolio strategy. Rather than maintaining rigid barriers between component asset classes and accounts, manage the portfolio as a whole.

No one knows where the capital markets will go—and that's the point. In an uncertain world, investors should have a well-defined, globally diversified strategy and manage their portfolio to implement it over time. Rebalancing is a crucial tool in this effort.

Dollar-cost averaging – Is it a sound investment strategy?

“Dollar-cost averaging” (DCA) is an investment approach that reportedly decreases certain risks over time. Unfortunately, there is a great deal of misunderstanding about DCA and the validity of the process. In theory, dollar-cost averaging allows you to invest smaller portions of your money over a longer period of time, reducing the chance that you pay a too high price for any individual investment. However, there is evidence that investing in the stock market as soon as possible with whatever money you have available, in order to form your ideal asset allocation, beats dollar-cost averaging in the long run.²

It is important to note that DCA is not the same as a continuous automatic investment programs available through 401(k) plans. With a 401(k) plan you don't have the option to either invest a lump sum or use DCA to invest your retirement funds. The regular continuous investment process of a 401(k) plan can be a great technique for building retirement savings and regular investment accounts, but it is not the same as DCA.

So the choice one may have to make it to invest a lump sum in the market all at once, i.e. take the plunge, or to wade into the market using the DCA approach. For example if you earn a \$10,000 bonus at work, and you decide to invest it in the stock market which approach makes more sense. Assuming you have designed a proper asset allocation (based on such factors as your goals, risk tolerance, tax status), you could invest it all at once or dollar-cost average the funds into the market by purchasing a set dollar amount of securities at predetermined intervals. An example for investing your \$10,000 bonus would be

to invest \$833 on the 15th of each month for 12 months. However, you may be better off over the long run to invest all \$10,000 at once.

The first issue with DCA is that no one makes an investment expecting the price to go down. But DCA works “better” *if the share price falls lower in the future than it is currently*. However, historic price information has shown that the stock market goes up more often than it goes down. That being the case, investors who use DCA would be better off the majority of the time to have invested earlier, rather than over a period of time. Dollar-cost averaging will never be able to make up lost ground compared to investing an available lump sum because you will, on average, dollar-cost average your way into higher prices.

The second problem of DCA is that it fails to address the higher transaction costs (dollars and time) of making more numerous, smaller acquisitions, which can eat into returns.

However, psychologically DCA may have a more important role. Spreading out the short-term exposure to any specific day’s stock price can make an investment in the stock market feel less risky. If you’d otherwise be concerned about your investments that might fall 1%-10%, or more in one day, dollar-cost averaging can help allay those fears. If you have those fears, you may want to reassess whether you’re comfortable with the risk of the stock market in the first place. So while easing worries is a legitimate benefit of DCA, let’s not confuse it with improving investment performance.

Endnotes

1 Gilbert L. Beebower , Gary P. Brinson, and L. Randolph Hood, “Determinants of Portfolio Performance .” Financial Analysts Journal 42, no. 4 (July/August 1986): 15-29.
Gilbert L. Beebower, Gary P. Brinson, and Brian D. Singer, “Determinants of Portfolio Performance II: An Update,” Financial Analysts Journal 47, no. 3 (May/June 1991): 40.
2 Truman A. Clark, “To Wade or Plunge”, October 2004, Dimensional Fund Advisors Inc..

If you have any questions on this topics, or need some help with other financial issues you are facing give me a call at (603) 373-8793.