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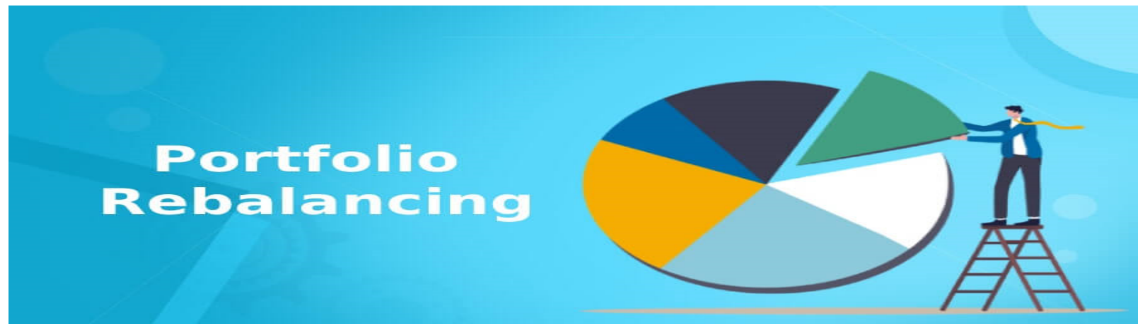
# Portfolio Rebalancing




Balancing our portfolio means **constructing a portfolio that fits our risk-bearing ability and investment goals**.

Once the portfolio is created, we have to **monitor it at least every quarter and take necessary action once a year** in case of any **rebalancing**. So, **we shouldn't just create a portfolio & forget it**.

Let's take a quick look at what we, as an investor, should know about balancing & rebalancing our investment portfolio:

- The meaning of **balancing** one's portfolio is to **have the right mix of investment assets** (usually stocks, bonds & gold) appropriate for **your risk tolerance, time horizon, and investment goals**.
- **Rebalancing** one's portfolio **allows us to maintain the desired level of risk over time**.
- **Portfolios naturally get out of balance** as the **prices of individual investments fluctuate** over time.
- **We can rebalance** our portfolio at **predetermined time intervals** or when our **allocations have deviated a certain amount** from your ideal portfolio mix.
- **Rebalancing can be done by selling an asset that has increased in value over the initial benchmark percentage or value set and buying another or allocating additional funds** to either stock, bonds, or gold.

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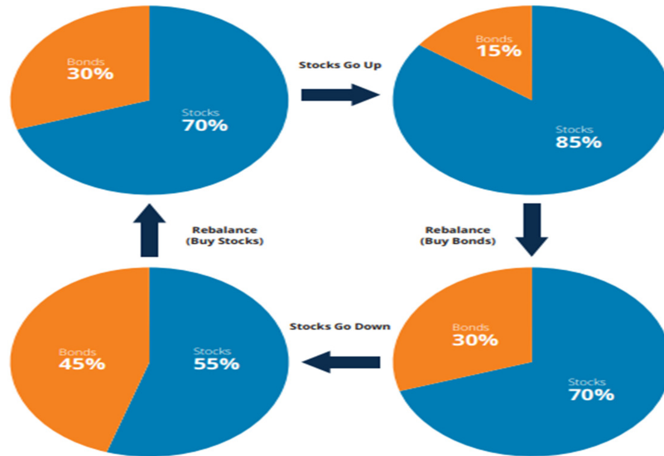


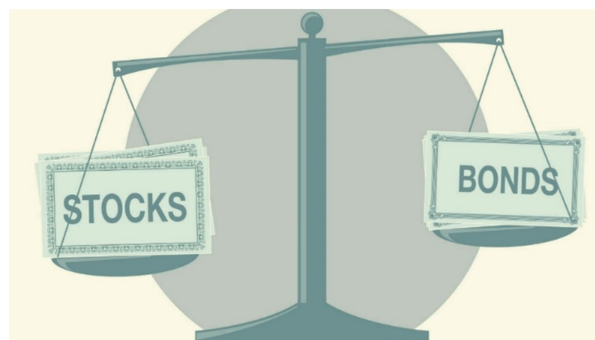

## Why is balancing and rebalancing a portfolio so important?

Balancing a portfolio is to **achieve our investment portfolio's desired risk and return potential proportions**. We first **design and commit funds to an investment strategy**, which we call **allocating our assets**.

Let's consider a simple example:

We may want **70% of our portfolio in stocks** and **30% in bonds**. When we initially fund our portfolio in this manner, we would consider it a balanced portfolio based on our risk profile. The problem here is that **these allocations in our portfolio don't stay the same over time**. Let's say the stock market's value doubles in three years while the value of the bond market grows but not nearly as much as stocks. The **value of the stocks in our portfolio would become much greater than the value of the bonds**, which puts **our investment portfolio significantly out of balance**. We can and should rebalance our investment account to maintain a balanced portfolio over time. If our original risk tolerance spurred us to invest 70% of our money in stocks, then our rebalanced portfolio should be 70% in stocks.

## How to rebalance your portfolio?

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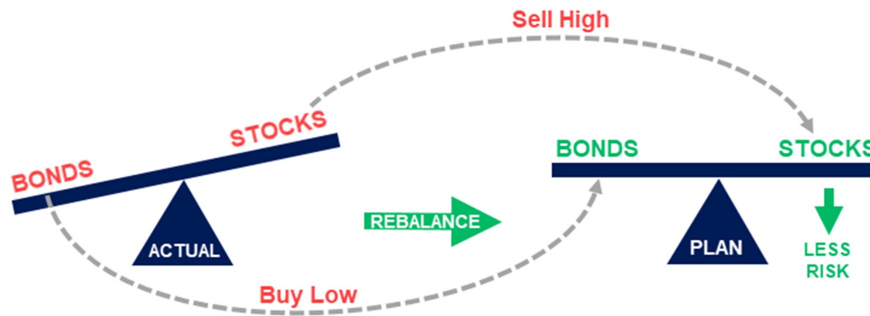
In a nutshell, Rebalancing means **selling one or more assets and using the proceeds to buy others to achieve our desired asset allocations**. Continuing with the example above, we would **sell some of our stock investments and put the money into bonds** or **buy more bonds to realign our asset allocation** with our risk tolerance.

**Which of these options sounds more appealing to you?**




1) **Sell high**-performing investments and buy lower-performing ones.

**OR**

2) **Allocate new money** strategically.

For example, if one **stock has become overweighted** in our portfolio, **invest new monies** into other stocks you like until **the portfolio is balanced** again. One may **prefer the second option** because rebalancing in the "traditional" way (without investing any additional money) **requires us to sell our highest-performing assets**.

Sometimes the **second option works** better since **rebalancing by contributing new funds** enables us to leave our winners alone to (hopefully) continue to outperform.

Let's consider a numerical illustration of both of the above Cases:

1) **Sell high**-performing investments and buy lower-performing ones.

Let us assume **we invest Rs 100000/-** with an **initial asset allocation of 70% Equity, 25% Bonds & 5% Gold**. **After 1-year**, **Equity has grown by 15%**, so our initial funding of **Rs. 70000/- is now increased to Rs. 80500/-**. The **Bonds invested have grown by 8%**, so our initial allocation of **Rs. 25000/- is grown to Rs. 27,000/-**. Similarly, **Gold has increased by 8%,** so our initial budget of **Rs. 5000/- is grown to Rs. 5400/-**. So the asset allocation regarding **Equity: Debt: Gold** after one year has increased to **71:24:5**.

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So, in this case, since the time horizon is almost one year, the growth in the asset has affected little, except Equity has increased by 1%. Per this strategy, we will book profits in Equity by 1% of cash value and shift **those funds into debt**.

2) **Allocate new money** strategically.

Let us assume the same example where **we invest Rs 100000/-** with an **initial asset allocation of 70% Equity, 25% Bonds & 5% Gold**. **After a period of 1-year, Equity has grown by 15%**, so our initial allocation of **Rs. 70000/- is now increased to Rs. 80500/-**. The **Bonds invested have grown by 8%**, so our initial funding of **Rs. 25000/- is now increased to Rs. 27,000/-**. Similarly, **Gold has grown by 8%**, so our initial budget of **Rs. 5000/- has risen to Rs. 5400/-**. So the asset allocation concerning **Equity: Debt: Gold** after one year has grown to **71:24:5**. So in this case, **we will add more money towards the intended asset class to bring back the asset allocation** ratio to 70:25:5. The overall portfolio value at the end of 1 year is Rs. 112900/-. So, **we will add approximately Rs. 1000/- to the debt** asset class. Doing this will bring back the asset allocation to the intended structure of 70:25:5. Also, we won't be touching the winning asset class as it might have a further rally.

## When should you rebalance your portfolio?

Once we've **determined our target asset allocation** and have **created a balanced portfolio**, the next logical question is, "**When should I rebalance my portfolio?**"

There are two general ways to approach rebalancing.

- We can rebalance our portfolio at a **specific time interval (say, yearly)**.

**OR**

- We can rebalance only when our portfolio becomes **unbalanced**.

**OR**

- When **markets** have **reached specific highs or lows**.

**OR**

- At the **Goal Realisation Stage**.

One significant advantage of portfolio rebalancing for long-term investors

When **market values plunge**, instinct tells us to **sell our holdings before conditions worsen**. Similarly, when the **market value rises,** and "everyone" is making money, that's when we want to **put our money into the market**. This is human nature, but it is also the **exact opposite of the strategy of buying low and selling high.**

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**Being essentially forced to sell high and buy low is one of the most significant benefits of maintaining a balanced portfolio over time.**

For example, if the **stock market crashes** and **equities lose 30%** of their value, then the **bond allocation in our portfolio is likely to become too high**. **Restoring balance** to our portfolio could **involve selling some of our bond investments and buying stocks** while they're cheap. Establishing a **balanced portfolio** and **taking steps to keep it that way** can **help us avoid relying too much on emotions** when making important investment decisions.

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