Step #12: Review And Adjust Your Investments

Your portfolio is diversified and you've developed an asset allocation strategy that you're comfortable with. All is well.

Then, at the end of the year, you find that the weighting of each asset class in your portfolio has changed. What happened? Well, over the course of the year, the market value of each security within your portfolio has earned a different return, resulting in a weighting change. That's why it's time to review and adjust your portfolio!

It's best to check your investment mix once a year. It's also a good idea to review your portfolio any time your financial circumstances change dramatically, whether it's for better or worse.

Rebalancing your portfolio regularly is like getting a periodic tune-up for your car. It minimizes your risk and ensures your portfolio is balanced according to your personal investing style and risk tolerance.

To illustrate the importance of reviewing and adjusting, let's compare a rebalanced portfolio to one where changes were ignored.

Let's say Joe has $50,000 to invest. He invests 50% in a bond fund, 10% in a Treasury bond fund and 40% in an equity fund.

At the end of the year, Joe's portfolio looks quite different than it did when he started out.

The equity portion of the portfolio soundly outperformed the bond and Treasury portions. This resulted in a significant change in his allocation of assets, increasing the percentage he has in the equity fund while decreasing the percentage invested in the Treasury bond funds.

Over the last year, Joe's $20,000 investment in the equity fund has grown to $27,600, an increase of 38%! Unfortunately, the bond fund took a loss of 5% and the Treasury fund had a modest increase of 4%. The overall return on Joe's portfolio was 13.1%, but now there is more weight on equities than on bonds.

Perhaps Joe decides to leave his portfolio unchanged and hopes his equity fund continues performing well.

If so, this unfortunately proves to be a bad choice. At the end of year two, the equity fund has performed poorly, losing 7% of its value. The bond fund performs well at the same time, appreciating 15%. Treasuries remain relatively stable with a 2% increase. His total portfolio value is now $58,284.5, realizing an increase of approximately 3.1%.

3.1% is OK, right? That depends. If Joe had rebalanced his portfolio after year one, his total portfolio value would be $59,268.5, therefore realizing an increase of nearly 5%. In this case, rebalancing is the optimal strategy.

So let's explore that a little more.

Joe's decision not to adjust his portfolio when equities were generating decent returns is a popular strategy among many investors. They assume an investment doing well over the past year will continue performing as well over the next year. Unfortunately, this is not the best strategy for investing success, because past performance may or may not be an indicator of future performance. Additionally, equity funds are always more risky and volatile, so having your portfolio favoring equities puts you at an increased risk. It's best to continue using caution and to rebalance your portfolio when one asset class severely outweighs the others.

Of course, there's always the chance the equity would have continued performing well in the second year and Joe would have lucked out with his choice. Generally, though, a portfolio should be balanced so a volatile equity doesn't outweigh other, more secure investments.

Here's how to rebalance your portfolio in three easy steps.

1.) Record

If you have determined an asset-allocation strategy that is perfect for you and you've purchased the appropriate securities in each asset class, keep a record of the total cost of each security purchase, as well as the total cost of your portfolio. These numbers will provide you with historical data of your portfolio. This way, at a future date, you can compare them to current values.

2.) Compare

Designate a date in the future for which you will review the current value of your portfolio and of each asset class. On that date, calculate the value of the funds in your portfolio by dividing current values of each asset class by your total current portfolio value.

Next, compare the weightings of each asset class in your portfolio with their original weightings. Are there any significant changes? If not, and you don't have a need to liquidate your portfolio in the short term, it might be better to remain passive.

3.) Adjust

If you find that changes in your asset class weightings have distorted your preferred balance and vulnerability to risk, you can rebalance it easily.

Simply take the current total value of your portfolio and multiply it by each of the percentage weightings you originally assigned to each asset class. The figures you calculate will be the amounts that should be invested in each asset class. This will revert your asset classes to their original balance.

Rebalancing your portfolio will allow you to implement any changes you make to your investing style. Essentially, rebalancing will help you stick to your investing plan even as the market fluctuates.

Congratulations on completing all 12 steps toward becoming a successful investor! We wish you the best of luck from here on. Don't forget to drop by American Southwest Credit Union to talk through financial advice of any kind!