Rebalancing: Rationale and Considerations

One of the most important aspects of the passive investment philosophy is maintaining an appropriate asset allocation throughout all phases of the market cycle. How your assets are allocated across various investments is determined by how much risk you need to take in order to target a certain return and accomplish your goals. Once the long-term strategic allocation is in place, it is the responsibility of the investment advisors at Passive Capital Management, LLC to rebalance the portfolio whenever the actual allocations deviate from the target allocations in a meaningful way; this disciplined process ensures that you are taking the appropriate level of risk regardless of the near-term market gyrations or headlines. Importantly, rebalancing eliminates human emotion (greed and fear) from the investment process and also neutralizes behavioral biases like overconfidence, regret avoidance, and the extrapolation of recent trends. In short, *disciplined rebalancing protects us from ourselves.*

It is important to note that rebalancing may not necessarily increase an investor's returns. However, rebalancing does enable an investor to capture a target return with less volatility than an un-rebalanced portfolio and this is very important. Achieving a given return, say 8%, with less volatility is necessarily better than achieving the same 8% return with more volatility. Unlike Olympic platform diving or gymnastics, there are no style points awarded in investing; adding degrees-of-difficultly to the investment process through market timing, buying/selling individual stocks, hiring/firing active managers, and giving up liquidity in alternative investments will oftentimes make it more difficult for you to achieve your goals. We can cross the road by doing somersaults but simply walking across the road is the better approach.

There are several ways in which we can rebalance a portfolio and the methods used are influenced by client circumstances, cash availability, tax efficiency, account type, and transaction costs. For example, we can rebalance a portfolio by:

- trimming the overweight position(s) and reinvesting the funds into the underweight position(s);
- allocating new cash to the underweight position(s) to avoid realizing a capital gain;
- keeping dividend payments in cash to use for rebalancing as needed; and
- conducting the rebalancing in a tax-deferred or tax-exempt account to avoid tax consequences.

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