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# Rebalancing



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## Rebalancing a Portfolio vs. Redesigning

### What is rebalancing or redesigning a portfolio?

If you are conscientious enough to design and track an investment portfolio, you will almost certainly have cause to rethink it at some point. You may be entering a new phase of life that requires a new investment horizon. Perhaps unexpected changes in your family or financial circumstances call for different strategies. Whatever the reason, it may be necessary or appropriate to make some changes to the composition of your portfolio.

#### *Redesigning*

You can change your portfolio through one of two basic strategies: redesigning or rebalancing. Redesigning, the more drastic of the two measures, involves dismantling your old portfolio and starting fresh with a new one made up of different investment categories. Although redesigning might be a viable option in extreme cases where every part of your portfolio has failed to meet your expectations, you should generally not choose this strategy based solely on investment performance.

However, when faced with a major life change such as retirement, you should definitely consider redesigning. If you are about to retire and have not done much to change your portfolio in 30 years, it may be time for a complete overhaul that reflects how drastically your investment needs and goals have changed since you were young. In such a case, the redesigning process might involve eliminating investment categories that are no longer appropriate, such as small cap stocks, while adding fixed-income bonds and others that suit your current needs.

You should not be too quick to totally redesign your portfolio, however. For example, while loss of a job certainly qualifies as a major life change, it does not necessarily mean that you should redesign. If you are panic-stricken over the sudden loss of income, keep in mind that it's probably only temporary. You may find a new job that instantly restores your financial security as well as the investment goals on which your original portfolio was built.

#### *Rebalancing*

Rebalancing involves restoring your original asset allocation by shifting your funds among investment categories to regain the ratios you decided on when you first designed your portfolio. You simply make changes as needed to bring your asset allocation back in line with the plan that you originally determined was appropriate for your investment objectives.

**Example(s):** Say that your original asset allocation scheme calls for 50 percent stocks, 30 percent bonds, and 20 percent cash equivalents. You have \$100,000, so you start out with \$50,000 in stocks, \$30,000 in bonds, and \$20,000 in cash equivalents at the beginning of the year. Over the course of the year, your stocks provide a 10 percent return, bonds a 5 percent return, and cash investments a 1 percent return. Consequently, assuming that you reinvested your earnings, at the end of the year you have \$55,000 in stocks, \$31,500 in bonds, and \$20,200 in cash. This means that the distribution of your assets has changed to 52 percent stocks, 30 percent bonds, and 18 percent cash.

**Caution:** The example above is for illustrative purposes only and does not represent the actual returns of any investment or portfolio.

This change in percentages may pose a problem because you chose the original percentages with the intention of maintaining them in accordance with your own particular risk tolerance and expected return. Since stocks now make up a larger percentage of your portfolio than you had once intended, the volatility of your portfolio may have increased.

There are a few simple ways to bring your portfolio back into alignment. You can sell some of your stock so that the ratio of stocks to other investments drops; you can add money to the portfolio and buy more bonds and cash equivalents; or you can do both. Many investment advisers recommend using shifts of 5 percent or more as a

trigger for rebalancing. Others recommend that it be done every year. Tax time or year-end is usually a good time to think about rebalancing.

**Caution:** You should consider the transaction costs and/or tax consequences that might result from rebalancing. For example, selling shares of a mutual fund as part of your rebalancing strategy might trigger capital gains tax and/or redemption fees.

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