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A Clean Slate: Review and Rebalance Your Portfolio

There is no better time to take a fresh look at your investment strategies than the beginning of the new year. And while there is no one-size-fits-all approach to investing for the future, reviewing your goals annually can help you stay on track from month to month--and year to year.

Progress Check

The goal of an investment review is to make sure you're in position to pursue important short- and long-term goals during the coming year. However, it is difficult to get a clear vision of the future without first reviewing whether you have managed to stay on track during the past year.

For example, ask yourself the following questions:

- Are your savings and investing goals still realistic, or might you now need to accumulate more (or less) money than originally planned?
- Has the time frame for any of your financial goals--such as your retirement date--changed in the past year?
- Have you been contributing as much as possible to your tax-deferred retirement accounts? The 2013 and 2014 contribution limits are $17,500 for employer-sponsored retirement accounts, such as 401(k)s and 403(b)s, plus another $5,500 in catch-up contributions if you are over the age of 50. For traditional and Roth IRAs, the limits are $5,500 with another $1,000 in catch-up contributions.

Correcting for Asset Allocation "Drift"

You should also be aware that your asset mix, or asset allocation, is always subject to change.[1] That's because investment performance could cause the value of some of your assets to rise (or fall) more than others. When an asset allocation shifts due to market performance, it is said to have "drifted" or become unbalanced.

To better appreciate how performance differences can affect a portfolio over time, consider what might have happened to a hypothetical portfolio of 70% U.S. stocks, 10% bonds, 10% foreign stocks and 10% cash equivalents if left untouched for the 20-year period ended December 31, 2012.

In this example, the original 70% allocation to domestic stocks would have grown to 79.4%, while all the other allocations would have shrunk, reducing their intended risk reduction role in the portfolio. As always, past performance is no guarantee of future results.[2]

Bonds haven't been as volatile as stocks over long periods of time, but recent history shows that they too can experience performance patterns that may alter asset allocation over time. Consider the divergence of the stock and bond markets in 2008 and how that affected asset allocations. While the S&P 500 lost 37% during this period, long-term U.S. government bonds gained 23%. A portfolio composed of 50% of each at the start of the year would have shifted to an allocation of 34% stocks and 66% bonds at year's end.[3]

Seeing the Whole Picture

If you have multiple investment accounts, determining whether to rebalance may involve several steps, beginning with a check of your overall allocation.[4] This entails figuring how your money is divided among asset classes in each account and then across all accounts, whether in taxable brokerage, mutual fund or tax-deferred accounts.

How often should you rebalance, and what are some general guidelines? The usual answer is anytime your goals change; otherwise, at least once a year. However, to keep close tabs on your investment plan and make sure it doesn't drift far from your objectives, you may prefer to set a percentage limit of variance, say 5% on either side of your intended target that would trigger a review and possible rebalancing.

How you go about rebalancing will depend on your particular circumstances. If you are making regular contributions to a retirement plan, the easiest way to adjust the makeup of your contributions is to build up underweighted assets. This avoids transaction costs and does not require liquidating and reinvesting assets, which can have tax consequences. In general, it's a good idea to avoid liquidating existing assets unless the tax consequences work in your favor.

If you must rebalance assets outside of your retirement plan, try to do it in another tax-deferred account such as an IRA, again to avoid immediate tax consequences. And if you're looking for new money to help rebalance your portfolio, consider using a lump-sum payment such as a bonus or tax refund.

[1]Asset allocation does not assure a profit or protect against a loss.

[2]Source: Wealth Management Systems Inc. The performance shown is for illustrative purposes only and is not indicative of the performance of any specific investment. The hypothetical returns used do not reflect the deduction of fees and charges inherent to investing. Your results will vary. Example is for the 20 years ended December 31, 2012. Domestic stocks are represented by the total returns of Standard & Poor's Composite Index of 500 stocks, an unmanaged index that is generally considered representative of the U.S. stock market. Bonds are represented by the total returns of the Barclays Aggregate Bond index. Money markets are represented by the total returns of the Barclays 3-Month Treasury Bills index. Non-U.S. stocks are represented by the total returns of the Morgan Stanley Capital International Europe, Australasia, Far East (EAFE®) index. It is not possible to invest directly in an index. Past performance is not a guarantee of future results.

Investing in stocks involves risks, including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price. Foreign investments involve greater risks than U.S. investments, including political and economic risks and the risk of currency fluctuations, and may not be suitable for all investors. Treasury bills are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, offer a fixed rate of return and fixed principal value.

[3]Source: Wealth Management Systems Inc. The performance shown is for illustrative purposes only and is not indicative of the performance of any specific investment. Your results will vary. Stocks are represented by the S&P 500, bonds by long-term U.S. government bonds, which are guaranteed by the U.S. government as to the timely payment of principal and interest, and, if held to maturity, offer a fixed rate of return and fixed principal value. Investors cannot invest directly in any index. Past performance does not guarantee future results.

[4]Rebalancing strategies may involve tax consequences, especially for non-tax-deferred accounts.