Consider regular rebalancing of your investments to help maximize returns and to potentially avoid being exposed to too much or not enough risk.

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Successful investors understand that deciding what to invest in—stocks, bonds and/or cash—is just the first step toward pursuing financial goals. You need to be vigilant about your mix of investments and their potential to pursue the rate of return you desire and the level of risk you’re prepared to shoulder.

Events in your life may necessitate a change to your portfolio’s mix, but over time market fluctuations can change the value of investments and your exposure to risk without you taking a single action.

To keep the amounts of stocks, bonds and cash in sync with the targeted percentages, you should consider periodic adjusting. This alignment process is known as “portfolio rebalancing.” It’s a critical and often overlooked maintenance step. By rebalancing on a systematic basis, your investments may be more likely to align with your goals.

Rebalancing also may help investors avoid trading on emotion. As markets or investments soar or fall, many investors succumb to fears that they may be missing an opportunity or risking their principal. Systematic rebalancing can help investors focus on the value of their entire portfolio and not just individual performance. In fact, research shows that investors could improve returns by as much as 5 percent if they don’t give in to reactive behavior like impulsive trading or buying high and selling low.¹

Benefits of Portfolio Rebalancing

This comparison shows the performance of two portfolios during the period 1987 to 2012. Each portfolio starts out with a traditional allocation of 60 percent stocks and 40 percent bonds. One is rebalanced annually, and the other is not. The rebalanced portfolio experienced lower volatility and higher risk-adjusted returns.

Start with the Appropriate Mix of Assets

Although no particular investment methodology can guarantee success, the first step in portfolio management is setting targets, a process known as asset allocation. How much money do you want to allocate to stocks, bonds or cash?

Stocks vs. Bonds

When you weigh the long-term performance of stocks against bonds, the results show how stocks have over the long haul performed better but have exposed investors to greater risk. These numbers are why, despite the risk, many investors, at least until retirement, choose to hold more stocks than bonds.

Do you want to consider alternative, sometimes more volatile investments, which may give you exposure to precious metals and other commodities or real estate? The mix you choose should reflect a level of risk that suits both your investment style and long-term financial goals.

Ultimately, how you allocate your assets among various investments affects how well your portfolio performs. Academic studies show that asset allocation decisions may be primarily responsible for the long-term return you achieve. Poor short-term performance in one particular asset class may be disappointing, but it should not be looked at in isolation. When you evaluate how your assets are allocated, remember that the big picture—how all of the assets work together to help you pursue your long-term investment goals—is what matters most. (See “Diversification: Consider Variety,” below.)

The targets you set will reflect not only your own ability to take risks, but also how long you have to pursue your goals. For instance, while stocks may provide the potential for long-term growth, you might consider investing a portion of equity holdings in more conservative investments as your high school student approaches graduation. The same is true for retirement. The closer you get, the less risk you may want to assume in your investment choices.

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The Danger of Setting and Forgetting

The second step of portfolio management is the ongoing maintenance of your asset allocation. Over time, your investments will deliver varying rates of return—stocks may outperform bonds or vice versa. Eventually, these market forces will cause the value of your holdings in various asset classes to change. So for example, if you started with a 60-40 allocation in favor of stocks, you may end up closer to 80-20 after a bull market like the U.S. experienced in the late 1990s during the tech boom and the resulting increase in the value of your equity holding.

This phenomenon, called “portfolio drift,” simultaneously changes your risk profile and may expose you to more than you want. While your stock holdings may be worth more, they also suddenly represent a larger portion of your overall portfolio and have unintentionally exposed you to more risk.

A systematic rebalancing would prompt you to take some of those profits and reinvest them in bonds to help bring your allocation back to your original 60-40 allocation. Some investors are hesitant to sell when the market is still up and maybe even rising, but by doing so you could potentially lock in your gains. This strategy, however, sometimes carries a cost. (See “The Costs of Rebalancing,” page 5.)

The assumption behind rebalancing is that anything unplanned that happens to your portfolio deserves scrutiny to make sure it is aligned with your goals, investment strategy, liquidity needs and risk tolerance.

The Discipline of Rebalancing

Rebalancing also imposes a degree of discipline in investing. With rebalancing, an investor would be prompted to take profits when investments perform better than expected and reinvest those returns in underperforming asset classes. That may feel counterintuitive since you may leave some profit on the table if you sell before an asset has peaked in value. It also seems riskier investing in an instrument that has been out of favor.

Portfolio Drift and Asset Weightings

The chart shows how a portfolio with a moderate 60-40 stock-to-bond ratio that was never rebalanced was pushed out of alignment several times between 1987 and 2012 by market trends, with its equity holdings rising to above 80 percent at times.

Source: Bloomberg, Merrill Lynch Investment Management & Guidance (IMG). Results shown are based on indexes and are illustrative. They are gross of fees, do not take into account tax implications or transactions costs, and assume reinvestment of income. Stocks and bonds are represented by the S&P 500 Total Return Index and the Barclays U.S. Aggregate Total Return Bond Index respectively. Asset allocation does not ensure a profit or protect against a loss in declining markets. Past performance does not guarantee future results.
If you have your doubts, consider what happened in the aftermath of the financial crisis of 2007–09. After a decline of about 53 percent in the S&P 500 between October 2007 and March 2009, many shell-shocked investors avoided stocks. But after such a steep decline, stocks were undervalued, and history shows it was, in fact, a good time to buy. (The S&P 500 Index doubled in value between March 2009 and May 2011.)

A Hypothetical Rebalancing

This example of what rebalancing a portfolio entails shows how an investor will take profits on stock gains to get that percentage back down to 60 and then buy bonds to increase that holding. While the sale of the stock may have lost some upside potential, the investor has clearly locked in the gain.

<table>
<thead>
<tr>
<th>ASSET CLASS</th>
<th>STOCKS</th>
<th>BONDS</th>
<th>CASH</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original allocation</td>
<td>$60,000</td>
<td>$30,000</td>
<td>$10,000</td>
<td>$100,000</td>
</tr>
<tr>
<td>Accumulated gains/losses</td>
<td>+8%</td>
<td>-3%</td>
<td>+1%</td>
<td>+3.4%</td>
</tr>
<tr>
<td>Balances/allocation over time</td>
<td>$64,800</td>
<td>$28,500</td>
<td>$10,100</td>
<td>$103,400</td>
</tr>
<tr>
<td>Action taken to rebalance</td>
<td>Sell $2,760</td>
<td>Buy $2,520</td>
<td>Buy $240</td>
<td></td>
</tr>
<tr>
<td>New balance</td>
<td>$62,040</td>
<td>$31,020</td>
<td>$10,340</td>
<td>$103,400</td>
</tr>
</tbody>
</table>

This is a hypothetical example of how to rebalance a portfolio meant for illustrative purposes only.

Keep in mind that, depending on the period of time being considered, rebalancing will not always produce higher returns immediately. For example, during a bull market for stocks, rebalancing requires selling assets that are trending higher while buying assets that are trending lower. At that point, a snapshot of a portfolio that has been rebalanced and one that has not may show an advantage to the one that has not been rebalanced. However, when the markets shift direction, the investor who has rebalanced has the potential to maintain higher returns.

Choosing a Rebalancing Method

There are several methods you can use to rebalance, and each has unique benefits, costs and risks. The one you choose is a matter of personal preference. Some common ones are:

• Periodic rebalancing: In this calendar approach to rebalancing, you set a schedule, such as annually, and rebalance your portfolio according to that time frame.

As the end of the year approaches, you would measure your actual investment mix against your target. Based on the variation and any changes in your personal circumstances, you would decide whether to make modifications or wait another year to rebalance.

• Tolerance-band rebalancing: With this approach, you establish specific thresholds that—if crossed—trigger rebalancing. Let’s say you decide that your target allocation for stocks is 60 percent, with a +/−5 percent range. Under this scenario, if a stock market rally causes your weighting to rise above 65 percent, you would sell some of your stock holdings to get back to your target 60 percent weighting. Conversely, if your weighting fell below 55 percent, you would sell bonds or money markets and use the money to restore your allocation to 60 percent.

The tolerance-band approach triggers transactions only when there is a significant change in your asset allocation. However, this approach means you must monitor your allocations more frequently than periodic rebalancing, which may only require you to check your weightings annually.

• Using other purchases and sales to rebalance: Often investors make regular portfolio contributions or withdrawals that can help them rebalance at a reduced cost. For example, if you make:

  Regular contributions to investment accounts: Consider investing some of that money in a category that has fallen below your designated allocation. For instance, if you own too much in stock-based investment vehicles or your stock holdings have appreciated beyond their allocation, you might use your contribution to buy a bond investment vehicle.

  Required minimum withdrawals from a retirement plan: You can use the money to reduce investment categories that have been inflated with rising prices.

If you do not make regular contributions or withdrawals, you can still save some rebalancing fees by being opportunistic. What if you get a bonus and you decide to invest it? You should use the money to help rebalance your portfolio. Even though you still will face fees, they will be less since you will not have to sell anything just to rebalance.
There is no hard-and-fast rule that says one method of rebalancing is better than another. Merrill Lynch recommends that investors consider a combination strategy, using both periodic annual rebalancing with tolerance bands of +/-5 percent for each asset class. That provides a reasonable balance between benefits and costs. You also may want to consider timing your annual review to coincide with any year-end search for tax losses that could potentially help offset gains in taxable accounts. The key to rebalancing is to select an approach in sync with your style of investing and stick to it.

**The Costs of Rebalancing**

Rebalancing usually requires you to sell certain assets and buy others, and these transactions come at a cost:

- If you trade stocks, you may be subject to commission charges.
- If you trade mutual funds, you could incur short-term trading fees or sales charges.
- If you trade bonds, you may pay dealer concessions.

There also may be tax consequences. If you sell a security held in a taxable account at a profit, you will be subject to short-term or long-term capital gains taxes. Transaction costs and taxes will detract from your long-term performance, so you may want to choose a process that requires a minimal number of transactions and realized capital gains.

These are costs you must incorporate into any decision on how frequently to rebalance. Most investors may not want to rebalance more than once a year, just to avoid losing too much of their return to transaction costs or taxes.

**Next Steps**

1. When was the last time you reviewed your portfolio’s asset allocation? If it’s been a while, it may be time to take a look.

2. Merrill Edge® clients can use the Merrill Edge Asset Allocator™ Tool to help them determine whether their current investments are in line with their targeted goals. Log on to [merrilledge.com](http://merrilledge.com) to access the tool.

3. If you are a Merrill Edge Advisory Center™ client, schedule an appointment with a Financial Solutions Advisor to discuss setting up a target asset allocation or choosing a method for systematic rebalancing.

4. Consult a tax professional as you consider sales of investments in your portfolio to learn about tax consequences of frequent trading.

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**Looking to Rebalance Your Portfolio? The Merrill Edge Asset Allocator™ Tool Can Help**

The online Merrill Edge Asset Allocator™ Tool guides you step-by-step through the process of developing your personal asset allocation plan. Here’s what to expect:

**Step 1. Take the Investor Profile Questionnaire.**

Nine questions will help pinpoint an investment style that meets your needs, considering factors like age and risk tolerance. The program will suggest one of five investment styles—each with a specific asset allocation—ranging from conservative to aggressive.

**Step 2. Compare your current portfolio to your target allocation.** The Asset Allocator will analyze your portfolio and identify discrepancies with your “ideal” allocation. It will then offer a prescription for changes that could help you align your investments with your chosen style. The tool will even offer suggestions for changes within asset classes.

**Step 3. Stay educated.** Merrill Edge has a variety of research and analysis on many investment types available online. Utilize the screening tools and performance history to help you make informed choices about your portfolio.

**Step 4. Get guidance.** Merrill Edge Advisory Center clients can talk to a Merrill Edge Financial Solutions Advisor for assistance at any step of the process.
Anil Suri  
*Managing Director, Chief Investment Officer, Multi-Asset Class Modeled Solutions, Investment Management & Guidance, Merrill Lynch Wealth Management*

Anil Suri leads the development of analytical solutions for goals-based wealth management, retirement investing, asset allocation and portfolio management as well as performance measurement across traditional, alternative and market-linked investments. Previously, he was a senior Alternative Investment & Asset Allocation Strategist within Merrill Lynch’s Research Investment Committee (RIC). Suri’s research has been published in *The Journal of Wealth Management* and discussed in Barron’s and *The Wall Street Journal*. Suri earned an M.B.A. with Honors from the Wharton School of the University of Pennsylvania, an M.S.E. from Princeton University, and a B. Tech. from the Indian Institute of Technology at Delhi.

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