

So You Think You Understand Reallocation?

By Candice McGarvey, CFP

Many investors believe reallocation takes place whenever they intentionally shift their portfolios' allocation because of an anticipated change in the market. But true reallocation – the strategy used by the pros – is much different than that. To correct the common misconceptions about reallocation, this illustration first explains what reallocation is **not**.

Reallocation is NOT:

- **A change in the underlying asset classes** - You do not reallocate by eliminating a specific asset class entirely. That would be a change in your portfolio design and if you adhere to Modern Portfolio Theory, such a modification would only be appropriate when there is a change in the investor's goals or life situation.
- **The replacement of a specific mutual fund with another fund** - The pros call it a “sell discipline” when they review the performance of a particular fund and consider replacing it with one that has superior characteristics.
- **Rebalancing** - When you sell a small amount of an asset class that is over-performing and purchase a small amount of another asset class that is under-performing, that's rebalancing. Your goal is to maintain the asset allocation that best fits your goals. The market's fluctuations will naturally produce differing returns in each of your asset classes, so rebalancing becomes crucial to the long-term achievement of your goals.
- **A sudden reaction to recent events** - Reallocation is a strategy implemented after careful consideration of market trends over a long period of time. For example, in 2001 and 2002 there was increasing research by the best finance and economic experts in the business pointing to a change in expected returns of several asset classes. Research suggested an upcoming decline in the long-term returns of large companies. Our firm shifted our portfolio allocations slightly as a result, but we considered the change for an extended period of time and reviewed copious research articles before coming to a conclusion.
- **A knee-jerk attempt to find a “solution”** -- During that same time period in mid-2002, many journalists and media reporters called our firm looking for a “solution” to that year's heightened volatility and lowered returns. Our “answer” seemed extremely dull at the time, but it was the same in every case—immediately sell concentrated positions, properly diversify into a well designed portfolio including equities and fixed income components, and ride out the storm. Reallocation should not be used as a fix for your emotional reaction during a period of declining returns. Instead, choose a portfolio allocation that will endure the tough markets and reduce your volatility in the long run.

Reallocation is: A shift in your portfolio's design as a result of careful analysis of market fundamentals, asset class research, and investor goals.

The most effective investors will create a portfolio design that meets their needs and not stray from it unless there is a significant reason. Occasionally, a slight shift in the portfolio design is warranted, such as in the following situations:

- Change in investor's goals - Suppose you decide to retire earlier than you had previously planned. The time horizon for your investments has changed, so you may need to position your investments less aggressively in anticipation of the withdrawal stage of your portfolio. *Being more aggressive in such a situation is not the answer.*
- Change in investor's life situation – such as unexpected death, a disabling injury, a divorce, or a marriage. All of these events will have a profound impact on your future finances and may warrant a reallocation of your investments.
- Change in market trends - This is probably the least valid reason to reallocate, and should be used with caution. Do not confuse the normal ups and downs of each asset class as a reason to reallocate. At any given point, some asset classes will outperform others, but their long-term trend is for the most part the same: they are all going up. Reallocation should not be confused with market timing, when you suspect a particular class is about to decline. But if there is a fundamental change in future risk and return expectations for a particular asset class, then reallocation may be warranted. If you have sufficient expertise to analyze the research and conclude that a change has occurred in an asset classes' risk-return parameters (this is considered *market timing*), then you have good reason to consider a reallocation of your portfolio. Otherwise, your best bet is to stick with your original portfolio design.