

## Time to Rebalance Your Investments?

Most investors have their money divided between stocks, bonds, and cash. If you have a plan for how you invest, that plan probably gives a target asset allocation - the percent of your investments you want in each of those asset classes. Your target asset allocation may use more specific categories, providing percentages for stock in large US companies (large cap), small US companies (small cap), foreign stocks, and others. Many investors own mutual funds in these categories rather than owning individual stocks or individual bonds.

The market turmoil of the past year may have significantly changed your asset allocation. Rebalancing is the process of bringing that allocation back to your target percentages. Many people rebalance on a schedule, say, once a year. Others use a trigger point, such as your allocation varying by 5% or more from your target. Unless you have already taken steps to manage your asset allocation over the past year, it's very likely that the drop in stock prices has thrown your asset allocation off by at least 5%.

How should you go about rebalancing? You can do it all at once, or bit by bit over a period of time. You could sell investments in the asset class you now own too much of (probably bonds or cash), and use the proceeds to purchase more of what's lost value (stocks). Or, you

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could direct new money, such as contributions to your employer retirement plan, into underweighted asset classes. Retirees who are taking distributions from retirement plans could take those distributions from asset classes that are over-weighted.

You could use interest, dividends, or capital gains to make new investments in the asset class you need to build up. This is the slowest approach, but it may be especially appealing if your investments are in a taxable account and selling would leave you with a taxable gain.

Taxes and transaction costs are two factors to consider before taking action.

- **Income taxes:** You can buy and sell investments within a retirement account without tax consequences. But if you sell an investment at a profit that's in a taxable account, you will have either a taxable gain to report on your income taxes, or a loss that you can use to offset other gains or, with certain limitations, regular income. For more information, see IRS Publication 550, Investment Income and Expenses (<http://www.irs.gov/pub/irs-pdf/p550.pdf>).
- **Transaction costs:** For certain types of investments, there are fees for purchases or sales, or penalties for taking money out or closing accounts. Examples include:
  - Commissions or broker fees for buying or selling stocks and bonds. Costs may be lower if you rebalance all at once, in a single transaction, rather than a series of smaller transactions spread over a period of time.
  - Loads for purchasing certain mutual funds (A shares), or back-end loads for selling them before a certain number of years have passed (B shares).

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- Surrender charges for taking money out of annuities before a certain number of years have passed.
- Early withdrawal penalty taxes for taking money out of retirement accounts before age 59½. For rules and exceptions, see *Rules for Taking Distributions from Tax-Deferred Retirement Plans* at <http://www.ace.uiuc.edu/cfe/retirement/takingdistributions2007.PDF>.)
- Frequent-trading fees: Some retirement plans impose fees on investors who exceed the allowed number of transfers. Certain mutual funds assess a charge if you transfer money out too quickly. Check your plan documents or mutual fund prospectus.

Rebalancing may well improve your investment returns over time, since it forces you to sell investments that have risen in value and purchase more in asset classes that have dropped. In a rising market, it will also protect you from taking on more risk than you intended. Rapidly rising stock prices can dramatically increase the proportion of your portfolio invested in stocks, making your portfolio more aggressive than your target allocation.

For more information about investments and retirement planning, visit University of Illinois Extension's website, *Plan Well – Retire Well, Your How-to-Guide* at [www.RetireWell.uiuc.edu](http://www.RetireWell.uiuc.edu).

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