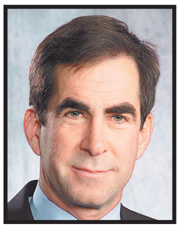
The Colorado Springs
BUSINESS JOURNAL

December 2, 2005

Portfolio rebalancing

Market timing that actually works



ALLAN ROTH

This article is about the most powerful market timing technique that has ever been developed.

Now before you check the title to be sure you're actually reading Allan Roth's column, it's true, I'm going to tell you to make gutsy moves in timing the market. Methods like technical analysis or Super Bowl games aren't a good way to time the market, but there is one way that actually works.

It's not a fad. It's a true contrarian strategy that goes against the heart of our fear and greed. It's called systematic rebalancing, and works for the following two reasons:

- Markets tend to revert to the mean. That translates to the tendency of hot asset classes to under-perform after they have run up and poor asset classes to improve.
- Human nature makes us performance chasers, which causes us to buy the hot asset classes that are about to revert to the mean and underperform.

Don't believe me?

The facts are that record amounts of money were pouring into stock mutual funds at the height of the stock market bubble while the reverse was happening at the post-bubble low. The terrible truth is that we crave the positive reinforcement that comes from running with the crowd.

In his recent book, "Unconventional Success," David Swensen notes that true contrarian investment behavior requires shunning the loved and embracing the unloved. It may not be natural, but it happens to be "supremely rational behavior." Mathematically, it gives your portfolio a bit of an extra boost.

Rebalancing is easy only in a theoretical world. You would simply set a target asset allocation, such as in the chart, and occasionally sell some of the best performing assets to buy the poor performing classes.

Unfortunately, in the real world there are taxable consequences, and anything that involves tax law just can't be easy.

It's important to remember, however, that taxes can eat up even more than investing fees and the complexities of tax-efficiency are a necessary evil. For that reason, I highly recommend seeing your tax accountant.

Here are a few rules of thumb in order of priority.

Harvest the tax losses. Yes, when you sell a loser, you are giving up the hope it might rebound and admitting you made a mistake. Yet the stock that has lost half its value is at least providing a tax-deduction. Harvest those losses you can use this year, even if you don't need it for rebalancing. Mark Patterson, tax manager at Stockman, Kast, Ryan and Co., warns to be careful of the wash sale rules and Alternative Minimum Tax consequences.

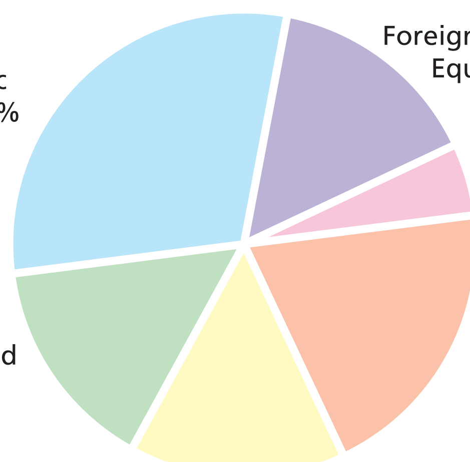
Put new money in the worst performing asset classes. If you are accumulating assets, steer your new money toward the asset classes that have become underweighted.

Rebalance in your tax-deferred or tax-free accounts. Don't pay taxes any sooner than you have to. If the first two rules don't get you to a balanced portfolio, then look at your 401Ks, IRAs, Roth IRAs, etc. Remember that it's best to put a greater percentage of your cash and taxable bonds in this part of your portfolio, as it dramatically increases tax-efficiency. Patterson recommends that we always keep an adequate amount of cash available in our taxable accounts for those unanticipated events in our lives.

Look next to long-term capital gains. Most people can accomplish rebalancing without paying taxes but it is far better to pay at 15 percent than at ordinary income tax rates. Things are getting even more complex here, so consult your tax advisor to make

Continued

Exhibit 1: Example of Equity Oriented Asset Allocation



If this were your target allocation, you would rebalance when your portfolio varied significantly.

Source: "Unconventional Success" by David F. Swensen sure you will not get bitten by the Alternative Minimum Tax.

Look last to short-term gains. This should be explored only as a last resort. If you are just a little unbalanced, I say don't trigger any short-term capital gains unless you have a capital loss carry-forward you can tap.

While these rules of thumb are not a substitute for seeking tax advice, they are intended to get you thinking on the subject.

'Tis not only the holiday season, but also the season to rebalance, since we now better understand our tax situation for the year. Rebalancing, however, shouldn't just be a year-end strategy. It should be done throughout the year as well.

As easy as it may be to imagine ourselves as individualist investors who can veer away from the herd when necessary, it takes a cognitive approach to really do so. To systematically buy low and sell high, that approach is tax-efficient rebalancing.

Be warned though, it's easier to establish a rebalancing policy than it is to keep your nerves steady and actually follow through. When you start to lose your nerve, remember that you are buying something on sale while the herd is rushing to buy the hot selling item that just had a price increase.

Allan Roth is a CPA and certified financial planner. He is the founder of Wealth Logic LLC, an hourly based financial planning and licensed investment advisory firm and an adjunct finance faculty member at the University of Colorado at Colorado Springs. He can be reached at 955-1001 or at ar@DareToBeDull.com.

Exhibit 2: Why Following Through on Rebalancing is So Hard

- Goes against human nature of running toward something loved and away from something shunned. Fear and greed make the opposite almost impossible to do.
- Losses hurt much more than gains feel good. Selling the up asset and buying the asset class you just lost money in will feel very wrong.
- You will need to do the opposite of what brokers and TV gurus are recommending. Yes, they urge the sale of yesterday's losers and purchase of yesterday's high performers. Product pushers know that we all buy investments based mostly on emotions and it's much easier to sell a hot investment.
- You will need to go against peer pressure. Friends won't hesitate to tell you what a dumb move it was to have bought that obvious loser. Remember how tough it would have been to buy "old economy" stocks in March 2000?
- In the unlikely event you have overcome the above emotional barriers, you may still have to deal with complex tax issues. Ugly stuff like the Alternative Minimum Tax and wash sales just makes it harder.
- You have to fight a powerful force – inertia. It's always easier to do nothing.