

Portfolio Rebalancing in a Low Interest Rate Environment: Consider Interest Rate Risk!

Ronald J. Rich, CFP®

Thomas M. Steinmetz, CFP®, CPA

Rebalancing your portfolio can be a good way to help keep your investment strategy on track towards meeting your goals. Doing it on a consistent basis can help maintain the soundness of your portfolio during market fluctuations, interest rates adjustments and life situation changes.

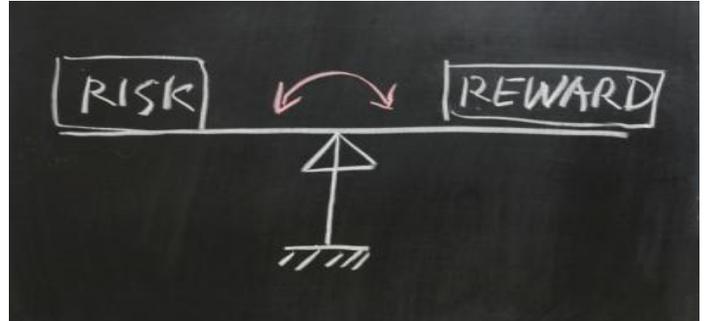
For the early part of 2019, equity markets headed higher. This upward movement came following a sharp decline to end 2018. Volatile markets remind us why investors should always consider adjusting or rebalancing their holdings. For example, you can move money from stocks into other asset classes, such as bond and money market funds. Another reason to consider rebalancing is to invest more in underrepresented asset classes until you achieve the overall allocations you want. With the most recent market movements, now may be a great time to conduct a full review of your portfolio.

What Is Rebalancing?

The term "rebalance" makes investing sound as simple as having your tires rotated or your car's alignment checked. The basic concept behind this exercise is mostly straightforward.

According to Investopedia.com, rebalancing is defined as the process of buying and selling portions of your portfolio in order to set the weight of each asset class back to its original state. In addition, if an individual's investment strategy or tolerance for risk has changed, he or she can use rebalancing to readjust the weightings of each security or asset class in the portfolio to fulfill a newly devised asset allocation.

Rebalancing your investment portfolio is a strategy that makes sense to use at regular intervals to ensure your investments are closely aligned with your long-



term financial plan. This generally means setting up periodic reviews of your portfolio's mix of investments. After a market rise, many investors lighten the upside (and downside) potential of equities with hopefully lower volatile returns of fixed income. While rebalancing does not assure superior performance, it helps keep portfolios updated on targeted asset allocations.

Traditional Rebalancing: Two Basic Actions

Traditional rebalancing usually has two simple actions.

Action One: When you design your investment plan, you decide on your ideal mix of equity and income allocations. You start by reviewing your personal situation which includes your long-term goals and risk tolerance. You then create a mix of investments that can best accommodate your risk tolerance and timelines.

Action Two: As your investment portfolio's value changes, you need to periodically your holdings to see how your personal mix of investments has moved with market changes. Then, consider adjusting your holdings to reflect your particular situation. For many investors, an investment review

session provides the ideal opportunity to reexamine your goals, age and risk appropriateness

When you complete a portfolio rebalance, your goal should be to sell what has increased and could potentially be high and buy what has not reached a greater value and is possibly low. Traditional rebalancing is a strategy that attempts to hold investors to a disciplined strategy.

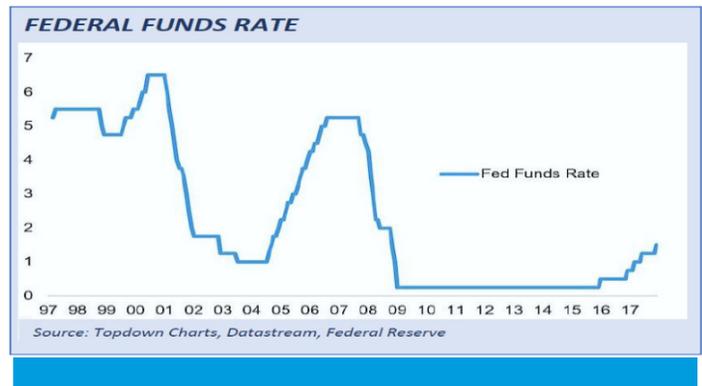
In keeping a balanced portfolio, bonds or interest rate sensitive securities have nearly always been considered a natural hedge to equities. Traditionally, bonds have usually gained or been more stable in value when stocks went down. This can be helpful if equity markets take a steep decline. Rebalancing is used to provide a continuous readjustment and it can keep people from letting emotions affect investments.

A traditional rule of thumb for investors has been "100 minus your age." This formula was a way of calculating roughly how much equity you should have. Applying that math, at age 40, your equity should be 60 percent and the rest should be fixed income. At 60, those numbers are reversed, with 60 percent in fixed income and 40 percent in stocks. When you have a mix of stocks and bonds in your portfolio, when stocks generate a higher return, they will become a larger percentage of your holdings. Conversely, when bonds do better than stocks, your portfolio balance will shift toward bonds. The specific allocation you choose should depend on your individual risk tolerance and investment goals.

In March of 2019, the Federal Reserve said it was pausing their raising of short-term interest rates. *Trading Economics* reported that, "Fed officials do not expect to make any changes to interest rate policy this year amid concerns about ongoing trade talks". In the minutes of their March meeting, the Fed cited Brexit negotiations and the possibility of a greater than expected economic slowdown in Europe and China as contributors to this stance. Policymakers also noted that "their views of the appropriate target range for the federal funds rate could shift in either direction based on incoming data and other developments."

Source: [TradingEconomics.com](https://tradingeconomics.com)

On a historical basis, interest rates are still low. For fixed income vehicles, when interest rates rise, bond



prices fall. Based on that scenario, rebalancing portfolios, which is typically a healthy practice, is now also an exercise in risk management and loss prevention.

The Consequences of Imbalance

A popular belief among many investors is that if an investment has performed well over the last year, it should perform well over the next year. Unfortunately, past performance is not always an indication of future performance. This is a fact many investors disclose, but still many investors remain heavily invested in last year's "winning" portfolios and may be underweighted in last year's "losing" positions. Remember, equities are historically more volatile than fixed-income securities, so the source of last year's large gains may translate into losses over the next year.

Normal rebalancing rules would suggest that with the large gain in stocks recently, investors should lighten up on equities and switch to fixed income investments to restore that balance. Due to low interest rates, a number of investing allocation experts are currently questioning the strategy of adding additional fixed income to portfolios.

So, what is another action you could you consider?

An Extra Action for Rebalancing

Action Three: When you design your investment plan, you decide your ideal amounts for fixed income.

As we stated earlier interest rates are still historically low. It can be near impossible to know if this will remain true in the next few years. Low interest rates can generate "interest rate risk." As defined by

Investopedia.com, “Interest rate risk affects the value of bonds more directly than stocks, and it is a major risk to all bondholders. As interest rates rise, bond prices fall and vice versa. The rationale is that as interest rates increase, the opportunity cost of holding a bond decreases since investors are able to realize greater yields by switching to other investments that reflect the higher interest rate. For example, a 5% bond is worth more if interest rates decrease since the bondholder receives a fixed rate of return relative to the market, which is offering a lower rate of return as a result of the decrease in rates.”

Due to increased interest rate risks, some investment professionals have looked elsewhere for income when appropriate. (i.e. the income-producing side of equities, or preferred shares). Prime rate money market funds or "laddering" with a series of short-term bonds provide other ways to address this problem. Low-duration debt reaches maturity in a short time so the fluctuation in price is not as great as long-term debt during a period of rising rates. While one- to five-year securities pay little in yield, at least investors may recover some or all of their invested capital when the security matures, unless they overpaid for the bonds in the secondary market. Longer term bonds may produce higher yields but are more vulnerable when rate changes or market fluctuations occur.

Recent market volatility has reminded investors that even if you feel equities are a good long-term investment, equities could possibly see a correction on the horizon. Short-term fixed income instruments may have low yields but could be less susceptible to volatility.



Rebalancing Focuses on the Long Term

High level financial strategists like Charles Ellis, Former Chairman of the Yale Endowment, who guided Yale's massive endowment with a rebalancing strategy based on diversified

investments that provided far above-average returns, advise high-income investors to take pains to make sure they rebalance to suit clients' needs. Ellis says personalized advice and individual goal-setting are key components of successful rebalancing strategy.

The long-term strategy behind a disciplined approach is to stick with asset allocations that you review on a periodic basis.

Final Thoughts on Rebalancing Your Portfolio

Your primary goal as an investor should be the overall success of your portfolio.

Changes in your lifestyle may warrant a change to your asset-allocation strategy. Whatever your preference, this guideline provides basic actions that can help you in rebalancing your portfolio:

1. **Record** - If you have recently decided on an asset-allocation strategy that is best for you, then after you purchase the appropriate securities in each asset class, keep a record of the total weightings you are attempting to hold in each asset class. These numbers will provide you with historical data of your portfolio.
2. **Compare** - On a chosen future date, review the current value of your portfolio and of each asset class. Calculate the weightings of each holding in your portfolio by dividing the current value of each asset class by the total current portfolio value. Compare this figure to the original weightings. Are there any significant changes?
3. **Adjust** - If you find that changes in your asset class weightings have distorted the portfolio's exposure to risk, take the current total value of your portfolio and multiply it by each of the (percentage) weightings originally assigned to each asset class. The figures you calculate will be the amounts that should be invested in each asset class in order to maintain your original asset allocation. You may want to sell positions from asset classes whose weights are too high and purchase additional investments in asset classes whose weights have declined. Before selling assets to rebalance your portfolio,

consider taking a moment to consider the tax implications of readjusting your portfolio. If you are adding new money to your portfolio, sometimes it might be more beneficial to simply not contribute any new funds to the asset class that is overweighted while continuing to contribute to other asset classes that are underweighted. Your portfolio might rebalance over time without you incurring capital gains taxes.

Conclusion

Rebalancing your portfolio can help you maintain an asset-allocation strategy and allow the implementation of any changes you may want to make to your investing style. The optimal frequency of portfolio rebalancing depends on your transaction costs, personal preferences and tax considerations, including which account you are rebalancing and whether your capital gains or losses will be taxed at a short-term versus long-term rate. This is where a qualified advisor can provide help.

The primary goal of rebalancing is to focus on minimizing an investor's risk by staying within targeted allocations. It is not a pursuit of maximizing your investment returns.

How often and how much of your portfolio you need to rebalance is where a qualified financial advisor can add value. Simple rebalancing suggests that your entire portfolio is performing well, and sometimes that might not be the case. Essentially, rebalancing tries to help you stick to your investing plan regardless of what the market does.

If you would like to discuss rebalancing your portfolio, please call us. Our goal is to understand our clients' needs and to monitor their portfolios. Our primary objective is to take the emotions out of investing for our clients. We can discuss your specific situation at your next review meeting or you can call to schedule an appointment. As always, we appreciate the opportunity to assist you in addressing your financial issues.



Keeping abreast of the constantly changing tax laws

is a challenge for anyone, which is why we regularly attend peer group meetings with people like Robert S. Keebler, CPA/PFS, MST, AEP (Distinguished), CGMA, one of America's most respected tax experts. After all, investments may be a matter of opinion but taxes are a matter of fact!

We are committed to helping you reduce your taxes.

Complimentary Financial Check-up

If you are currently not a client of Capstone Wealth Advisors, we would like to offer you a complimentary, one-hour, private consultation with one of our professionals at absolutely no cost or obligation to you.

To schedule your financial check-up, please contact Teresa

at 317-577-8233 or tbarthuly@capstonewa.com

and we'd be happy to assist.

This article is for informational purposes only. This information is not intended to be a substitute for specific individualized tax, legal or investment planning advice as individual situations will vary. For specific advice about your situation, please consult with a lawyer or tax professional. The views stated in this letter should not be construed, directly or indirectly, as an offer to buy or sell any securities mentioned herein. Investing involves risk including the potential loss of principal. No investment strategy, such as rebalancing and asset allocation, can guarantee a profit or protect against loss. Rebalancing investments may cause investors to incur transaction costs and, when rebalancing a non-retirement account, taxable events will be created that may increase your tax liability. Indexes are unmanaged and investors are not able to invest directly into any index. Past performance is no guarantee of future results. In general, the bond market is volatile as prices rise when interest rates fall and vice versa. This effect is usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss. The payment of dividends is not guaranteed. Companies may reduce or eliminate the payment of dividends at any given time. This article provided the Academy of Preferred Financial Advisor, Inc. APFA, Inc.®