Retirement Weekly

How to approach rebalancing your portfolio this year

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It’s not a good idea to rebalance your portfolio at preset intervals

Is it worthwhile to rebalance this year? GETTY IMAGES/ISTOCKPHOTO

Portfolio rebalancing may not be a good idea this year. You may want to avoid it altogether.
I’m referring to the process of bringing each asset’s portfolio weight back into line with its assigned weight. That involves selling marginal portions of assets that have performed better than average and buying additional shares of assets that have lagged. Though you can rebalance at whatever frequency you desire, investors most commonly do so in December.

Rebalancing seems like an utterly obvious and unobjectionable thing to do. After all, if you didn’t ever rebalance, then over time your best-performing asset would grow as a share of your portfolio and eventually come to dominate it. In that event, your portfolio’s risk would increase far beyond what you desire.

One consequence of rebalancing being so obvious, however, is that few ever stop to wonder whether there are better or worse ways to go about it. That’s unfortunate, since there very much are times you would want to avoid it—and this year may be one of them.

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According to various researchers, three preconditions must be true before rebalancing stands a good chance of improving your performance. Here’s how this year-end stacks up against those preconditions:

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Uncorrelated assets

The first precondition is that the assets in your portfolio must to at least some extent be uncorrelated, meaning that some will be performing better when others are performing poorly. While this is generally true for stocks and bonds, it is not this year, since bonds have performed just as poorly as stocks.

Consider what your portfolio allocation would be today if you began this year with 60% allocated to the stock market and 40% to bonds. Assuming you invested in total-market index funds, your current allocation would be 59.4% in stocks and 40.6% in bonds. That's not a big enough deviation from your portfolio's default allocation to make it worth your while even bothering with rebalancing.

Mean reversion

Another precondition making rebalancing worthwhile is that your portfolio's assets are mean reverting. In other words, after above-average performance in a given period, an asset will tend to be a below-average performer in the subsequent period—and vice versa.

The opposite of mean reversion is momentum or trend following. And to the extent these contrary conditions exist, rebalancing actually makes matters worse, because by doing that you will be periodically investing more in your losing asset(s) just as they are poised to lose even more.

The third precondition is related to the second: The mean reversion must occur at the same frequency of your rebalancing. So even if mean reversion exists, rebalancing near the end of the year would still not be a good idea unless the assets your portfolio owns tend to mean-revert annually in December.

<table>
<thead>
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<th>% of all years since 1793 in which asset rose</th>
<th>Following years in which asset rose, % of time asset rose in subsequent year</th>
<th>Following years in which asset fell, % of time asset rose in subsequent year</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds</td>
<td>73.5%</td>
<td>79.4%</td>
<td>57.4%</td>
</tr>
<tr>
<td>Stocks</td>
<td>69.5%</td>
<td>71.8%</td>
<td>64.3%</td>
</tr>
</tbody>
</table>

Do the stock and bond markets satisfy these second and third preconditions? I am struck by how few investors have ever asked this question, much less attempted to answer it.

The data in the accompanying table are the beginning of an answer to this question. Notice that it's a mixed picture for both stocks and bonds. On the one hand, the odds of either asset rising in a given year decline if they have also fallen in the prior year as well. That's not what you'd hope to see if you're counting on mean reversion. On the other hand, notice that the odds of rising in that second year are still greater than 50%.
An even more revealing measure is to focus on stocks' performance relative to bonds. Since 1793, stocks have outperformed bonds in 56.2% of the years. Following years in which stocks underperformed bonds, stocks the subsequent year beat bonds 57.6% of the time. That 1.4 percentage point increase reflects an awfully modest reversion to the mean.

**Strategic Rebalancing**

There may be a way forward, however, according to a study co-authored by Campbell Harvey, a finance professor at Duke University, and three researchers at London’s Man Group. They call their suggested solution “Strategic Rebalancing.”

The key to their approach is to not rebalance at preset intervals, but only when the assets in your portfolio are not exhibiting momentum or trend-following behavior. To the extent your losing assets remain in a well-defined downtrend, you would **not** rebalance.

To be sure, there’s no surefire way of pinpointing these downtrends. But the researchers report that you don’t have to be perfectly accurate to make Strategic Rebalancing worthwhile. One approach they suggest is to use a moving average crossover model to decide whether the trend is up or down—focusing on two moving averages of different lengths. You would rebalance only when your losing asset’s shorter moving average crosses above the longer one.

Consider, for example, a crossover model based on the 50-day and the 200-day moving averages. According to this particular version of the model, the trend currently remains down for both a total stock market index fund and a total bond market index fund. The 50-day moving average for the former is 7% below its 200-day, and for the latter it is 6% below.

The bottom line? The upcoming year-end period does not meet any of the preconditions that would make rebalancing worthwhile. So don’t bother.

That’s one less thing you have to worry about this holiday season!

*Mark Hulbert is a regular contributor to MarketWatch. His Hulbert Ratings tracks investment newsletters that pay a flat fee to be audited. He can be reached at [mark@hulbertratings.com](mailto:mark@hulbertratings.com)*.
Are you fit for your age, or are you frail? Here's how to find out.

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When Should You Claim Social Security?

Age
47

Annual Income
$110,000

See How Claiming Earlier or Later Affects Your Benefit

<table>
<thead>
<tr>
<th>Lifetime Benefit</th>
<th>Monthly Benefit</th>
</tr>
</thead>
</table>

AGE 62
Earliest you can claim

67
Your Full Retirement Age (FRA)

70
Age you qualify for the max monthly benefit

Gender

Male
Female

Anticipating Living Into
70s
90s

Marital Status
Single

Show Results

Read Important Information
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