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A rebalancing act for wary investors

By Rob Carrick
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This simple formula for altering your stock and bond mix can protect you from downturns and take advantage of market gains

A list of what-ifs for investors looking back to the start of the stock market crash one year ago:

What if you sold your stocks one year ago and sat out the carnage?

What if you jumped back into the market in the early spring, just as the seemingly unstoppable market rebound began?

What if you got past your investing fantasies of the past year, your regrets, your mistakes, your good intentions gone awry and your bad habits indulged? What if you accepted the most basic fact of investing and moved on.

"Just admit it," said Jon Palfrey, vice-president at the Vancouver-based money management firm Leith Wheeler. "You can't predict the market."

So stop trying to anticipate the best times to get in and out of the market. Instead, consider a super-simple strategy that offers a degree of protection against down markets and ensures you get a taste of rising share prices. It's called rebalancing and it addresses the biggest lesson of the past year, which is that you never really know what the market is going to do next.

Rebalancing works on the following idea: Find a mix of stocks and bonds that suits your needs and stick with it, no matter what the markets are doing. In other words, it takes the guesswork and the randomness out of investing and imposes order.

"Rebalancing offers some discipline - a process - instead of emotions," Mr. Palfrey said.

Let's say you're a moderately aggressive investor and you find that having 60 per cent of your portfolio in stocks and 40 per cent in bonds is ideal from the standpoint of addressing risk and still getting you the returns you need to achieve your goals.

Some experts recommend rebalancing every six months; Mr. Palfrey suggests quarterly adjustments. Either way, you revisit your portfolio to make any adjustments required to get back to the 60:40 mix.

In the middle of 2008, when the stock markets were peaking, you most likely would have sold some of your stock market exposure as part of a rebalancing and added bonds. As stocks fell, government bonds rallied because they're much safer. By year's end, your rebalancing would have meant buying stocks or equity funds with money taken out of your strong bond holdings.

Since then, the stock markets surged higher and the stocks you picked up in the past six months should have grown in value. Next order of business: Get your stock market exposure back down to 60 per cent as of your next quarterly rebalancing.

The first step in adopting a rebalancing program is to get your asset mix right. The key here is to consider your ability to live with the risk of losing money, said Norman Raschkowan, chief investment officer at Mackenzie Financial.

One of the lessons of the past year was that too many people have overestimated their ability to stand big losses in their portfolio, Mr. Raschkowan said.

"The reality is that people have a conceptual view of what their risk tolerance is," he said. "But when they actually see their investment values dropping, they discover that perhaps their risk tolerance wasn't what they thought it was."

Two elements that Mr. Raschkowan suggests you throw into your thinking about risk are your time horizon, or the length of time until you will need the money you're investing, and the amount of money you can afford to lose without blowing up your financial plan.

Don't let the rapid improvement in the stock markets influence your thinking on risk tolerance, he added. "I certainly hope that people will recall the urgency and the unease that they felt six months ago."

It's worth noting that while the S&P/TSX composite index is up close to 50 per cent from its low of the past 12 months, it's still down about 25 per cent from its peak in June, 2008. This highlights how nasty the math of investing can be. If your portfolio loses 50 per cent of its value, you need a return of 100 per cent to get back to where you started.

The big appeal of regular rebalancing is that it takes all the guesswork out of investing. You simply follow your blueprint.

But Sadiq Adatia, chief investment officer at Russell Investments Canada, said there's a case to be made for going beyond your usual limit for stocks when the markets plunge like they did in the past 12 months.

"The markets don't give us these gifts very often, so when they do, you have to take advantage of it," Mr. Adatia said.

He suggests straying no more than five to 10 percentage points off your usual level of stock market exposure. Then, when stock prices have returned to more normal levels, you'll move your mix of assets back to the original model.

There's a way to capitalize on hard-hit markets while still staying within your usual asset mix, Mr. Adatia added.

You simply get a little more aggressive within that mix by, for example, mixing corporate bonds in with your government bonds or guaranteed investment certificates, or choosing more aggressive stocks or sectors.

Now, what if you're behind on your rebalancing? Like, say, you're one of those investors who has helped contribute to the massive $67-billion now sitting in money market funds that are earning pretty much nothing right now as a result of low short-term interest rates.

Bob Gorman, chief portfolio strategist at TD Waterhouse, said the bulk of the stock market rally has involved the stocks that were hurt most in the bear market, notably small companies and those in riskier sectors.

"What's been left behind are those companies that are higher quality, less economically sensitive with high dividends and excellent prospects," Mr. Gorman said.

Examples of such companies include Power Corp. of Canada, a holding company with large holdings in financial services; Bank of Nova Scotia; Shoppers Drug Mart; and two companies with a big presence in the cable television business, Rogers Communications and Shaw Communications. All pay a dividend yielding anywhere from 2 to 4.5 per cent.

"This is where you go, in my opinion, to get high risk-adjusted returns," Mr. Gorman said.

"You'll have a decent stream of income, particularly on an after-tax basis, and you'll be able to sleep at night."

Rebalancing Act

Rebalancing means finding the right mix of assets for your personal situation and then adjusting your holdings periodically to ensure that you stick to your blueprint. Here's how rebalancing would have worked over the past year of stock market volatility for someone with an asset mix of 60 per cent stocks and 40 per cent bonds.

	Total Portfolio Value	**Stocks $**	**Stocks %**	**Bonds $**	**Bonds %**
Markets Rising...					
The portfolio on Jan. 1/08	$100,000	$60,000	60%	$40,000	40%
The portfolio on June 30/08	$102,140	$62,460	61%	$39,680	39%

What to do: Sell $1,176 of your stock holdings and buy bonds

Result: you would have slightly lowered your exposure to the ensuring stock market plunge

	Total Portfolio Value	**Stocks $**	**Stocks %**	**Bonds $**	**Bonds %**
Markets Plunging...					
The portfolio on June 30/08 (after rebalancing)	$102,140	$61,284	60%	$40,856	40%
The portfolio on Dec. 31/08	$79,419	$37,996	48%	$41,423	52%

What to do: Sell $9,655 of your bond holdings and buy stocks

Result: you would have increased your exposure to further market declines in January and February, and then a sharp rally that continues today.

Note: Portfolio returns are pegged to investment products tracking benchmark Canadian stock and bond indexes.

Source: Rob Carrick