Rebalancing

Keeping Your Portfolio on Target — Lesson Explainer

The Concept

If stocks rally while bonds stay flat, stocks naturally grow to take up more than their original share - not from any action, just because they grew faster. Left alone, a portfolio quietly drifts toward higher risk.

Rebalancing means periodically trimming oversized positions and topping up shrunk ones, back to target - a disciplined 'sell high, buy low' that doesn't depend on predicting anything.

Two common approaches: calendar-based (fixed schedule) and threshold-based (rebalance when drift exceeds a set amount). What matters most is having a rule and following it.

Illustrative Example: A 60/40 Portfolio After a Stock Rally

Stage	Stocks Value	Bonds Value	Stocks %	Bonds %
Starting Portfolio ($100,000)	$60,000	$40,000	60%	40%
After a Strong Stock Rally	$84,000	$42,000	67%	33%
After Rebalancing Back to 60/40	**$75,600**	**$50,400**	**60%**	**40%**

Stocks drifted from 60% to 67% - nobody chose that, it just happened. Rebalancing means selling $8,400 of stocks and buying $8,400 of bonds to restore the 60/40 target.

5 Things to Know About Rebalancing

1. Drift happens automatically - strong performers simply grow faster.

2. Rebalancing systematizes 'sell high, buy low' without needing to predict anything.

3. Calendar-based and threshold-based are both valid - the key is having a rule and following it.

4. Rebalancing can have costs - trading fees and potential tax consequences.

5. It's emotionally uncomfortable by design - selling winners to buy laggards feels wrong.

4 Things to Check When Rebalancing

• Pick a rule and stick to it - calendar or threshold-based, either works if followed.

• Watch trading costs - frequent rebalancing racks up fees and possible capital gains tax.

• Use new contributions first - directing deposits to underweight positions rebalances without selling.

• Expect the discomfort - if it doesn't feel uncomfortable, you're probably not actually doing it.

> **Worth knowing:**
> rebalancing is a risk-management discipline, not a way to boost returns on its own - its main job is keeping your portfolio's risk level where you actually intended it.

Quiz — Answer the questions, then check the key on the next page

1. Why does a portfolio's allocation drift even if you never trade?

A. It doesn't - allocations stay fixed unless you actively change them
B. Because brokers automatically change your holdings
C. Because different assets grow at different rates, shifting their share of the total
D. Because of currency exchange rates only

2. What does rebalancing mechanically involve?

A. Buying more of whatever has performed best recently
B. Trimming positions that have grown oversized and topping up ones that have shrunk
C. Selling your entire portfolio and starting over
D. Never touching your portfolio under any circumstances

3. What are the two common rebalancing approaches mentioned in this lesson?

A. Random and emotional
B. Daily and hourly
C. Only when a financial advisor tells you to
D. Calendar-based (fixed schedule) and threshold-based (drift trigger)

4. Why should rebalancing not be done excessively often?

A. Trading fees and potential capital gains tax add real costs
B. It's illegal to rebalance more than once a year
C. Rebalancing has no costs, so frequency doesn't matter at all
D. Rebalancing always increases your allocation to stocks

5. Why did rebalancing feel emotionally uncomfortable in the illustrative example?

A. Because it required predicting the market's next move
B. Because it involved no actual trading
C. Because it meant selling the recently-strong performer to buy the laggard
D. Because bonds are always a bad investment

Answer Key

1. Why does a portfolio's allocation drift even if you never trade?

Correct answer: C. Because different assets grow at different rates, shifting their share of the total

Stronger-performing assets naturally grow to take up a larger share of the portfolio over time.

2. What does rebalancing mechanically involve?

Correct answer: B. Trimming positions that have grown oversized and topping up ones that have shrunk

Rebalancing means selling some of what's grown and buying more of what's lagged.

3. What are the two common rebalancing approaches mentioned in this lesson?

Correct answer: D. Calendar-based (fixed schedule) and threshold-based (drift trigger)

Calendar-based happens on a fixed schedule; threshold-based triggers when drift exceeds a set amount.

4. Why should rebalancing not be done excessively often?

Correct answer: A. Trading fees and potential capital gains tax add real costs

Rebalancing has real costs, so excessive frequency erodes its benefit.

5. Why did rebalancing feel emotionally uncomfortable in the illustrative example?

Correct answer: C. Because it meant selling the recently-strong performer to buy the laggard

Selling what's been winning to buy what's been lagging feels counterintuitive in the moment.