Managing Risk With Portfolio Rebalancing

The risk and return of rebalanced versus non-rebalanced portfolios

TD Ameritrade
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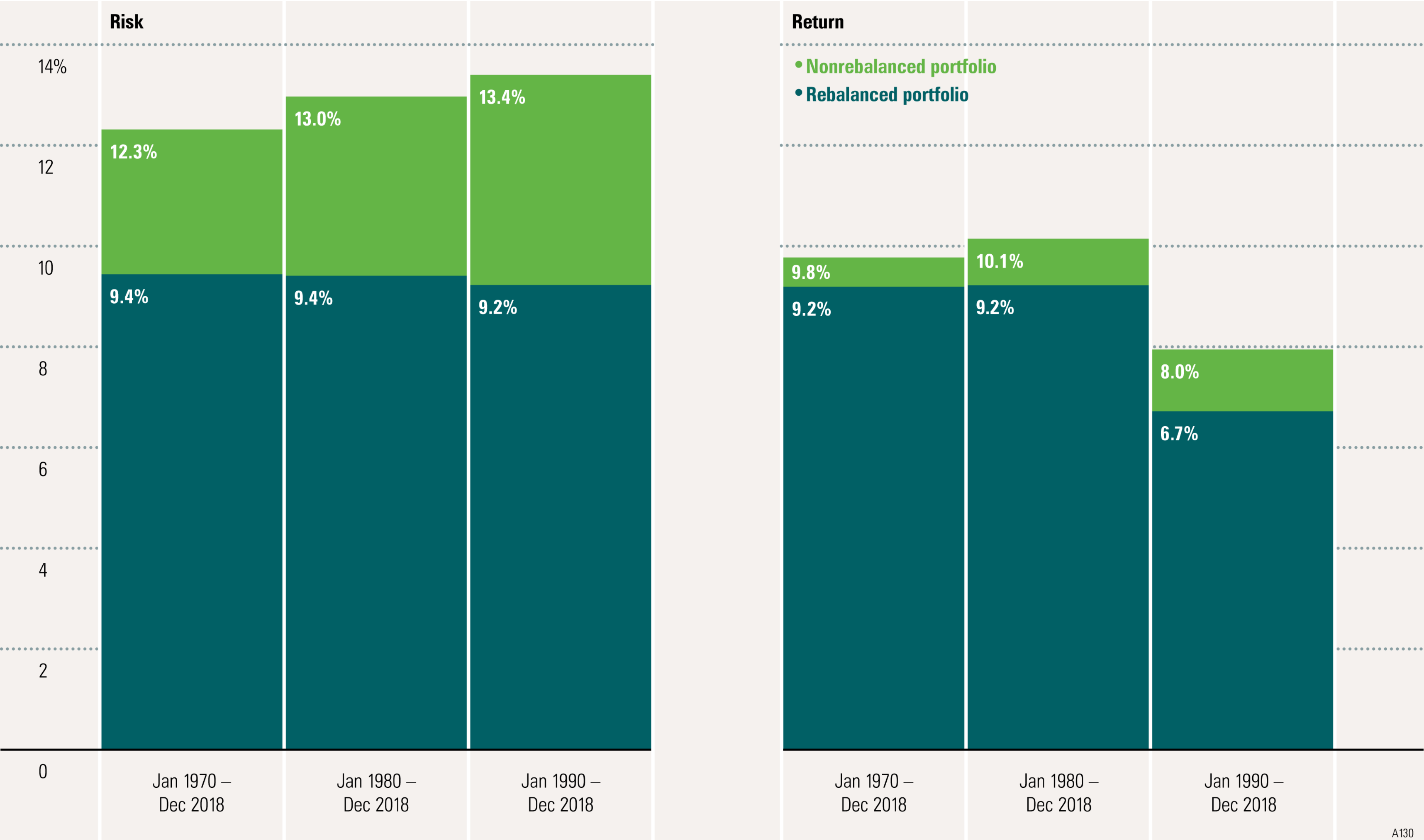

Past performance is no guarantee of future results. Risk and return are measured by monthly annualized standard deviation and compound annual return, respectively. This is for illustrative purposes only and not indicative of any investment. An investment cannot be made directly in an index.

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Over time, an investor's portfolio asset-allocation policy can get disturbed by market ups and downs. For example, stocks tend to outperform bonds in the long run. Since stocks are riskier than bonds, a greater allocation in stocks can also increase portfolio risk. Rebalancing is an essential account-management tool that helps keep the portfolio within the risk tolerance level that is comfortable for the investor's asset-allocation strategy.

The image compares the risk and return of portfolios that were rebalanced to those that were not rebalanced over three different time periods. Risk and return were measured by monthly annualized standard deviation and compound annual return, respectively. Standard deviation measures the fluctuation of returns around the arithmetic average return of the investment. The higher the standard deviation, the greater the variability (and thus risk) of the investment returns.

The returns for the nonrebalanced portfolio were higher in all three time periods. However, the risk was also considerably higher. In all three time periods, the rebalanced portfolio had a much lower risk than the nonrebalanced portfolio. This illustrates how rebalancing can help manage risk.

Diversification does not eliminate the risk of investment losses. Government bonds and Treasury bills are guaranteed by the full faith and credit of the U.S. government as to the timely payment of principal and interest, while stocks are not guaranteed and have been more volatile than bonds. International investments involve special risks such as fluctuations in currency, foreign taxation, economic and political risks, and differences in accounting and financial standards.

About the data

Each portfolio consists of 60% stocks, 30% bonds, and 10% cash at the portfolio begin date. The 60% stock allocation consists of 30% large, 15% small, and 15% international stocks at each portfolio begin date. The bond allocation consists entirely of five-year U.S. government bonds, while the cash allocation consists of 30-day U.S. Treasury bills. The rebalanced portfolio has been rebalanced monthly.

Large stocks are represented by the Ibbotson® Large Company Stock Index, small stocks by the Ibbotson® Small Company Stock Index, and international stocks by the Morgan Stanley Capital International Europe, Australasia, and Far East (EAFE®) Index. Government bonds are represented by the five-year U.S. government bond, and cash by the 30-day U.S. Treasury bill. An investment cannot be made directly in an index. The data assumes reinvestment of income and does not account for taxes or transaction costs.