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OPINION

A 2015 'Rebalancing' Act for Investors

With stocks flying high, your portfolio may have become unbalanced, overexposed to equities.

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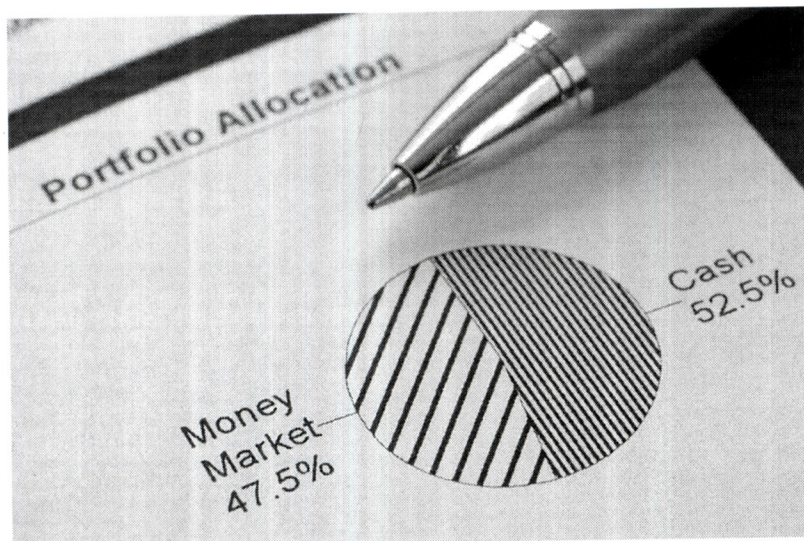
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The start of the New Year is a good time to examine your investment portfolio in the interest of reducing risk. With rising U.S. stock prices and low volatility over the past two years, your portfolio is likely to be riskier than it should be. The classic mistake individual investors make is to allow risk levels to increase when times are good and then to panic and liquidate their equity holdings during periods of crisis. When times are good and equity prices are high, investors should be making midcourse corrections to lower risk.

While no one can predict the future, stocks and bonds in the U.S. are very richly valued, suggesting that future long-run rates of return will be lower than in the past. Stocks are selling at about 27 times their cyclically adjusted earnings per share (the so-called CAPE multiple), and these valuations have only been higher during the late 1920s and at the height of the dot-com bubble in 2000. The 10-year U.S. Treasury bond yields just over 2%, a rate that is unusually low and about equal to the Federal Reserve's target inflation rate.

It would be imprudent to rely on low market volatility continuing. Investors whose portfolios have become more exposed to risk would be well served by employing some time-honored techniques to mitigate risk.

One of these is diversification. With valuations in foreign stock markets significantly lower than in the U.S., diversification ought to include investments in those markets. Depreciated currencies in Europe and Japan will give foreign multinational corporations a competitive price advantage in 2015. Moreover, Japan and Europe's sluggish economies should start to do a little better in 2015. Germany appears to have already turned the corner and Japan should benefit from rescinding scheduled tax increases. Emerging markets, with their younger populations, will continue to grow faster than the developed world.



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Investors should allocate at least 25% of their equity portfolios to foreign markets. While a decline in the U.S. market is likely to spread around the

world, the performance of different national markets will not be the same. The U.S. stock market was flat during the January 2000 to December 2009 period, while emerging-market equities produced 10% average annual returns. If your stock portfolio consists entirely of U.S. companies, broader equity diversification is likely to reduce portfolio risk and increase returns.

Bond portfolios should also be broadly diversified. While a "total bond market" portfolio appears to be well diversified, more than two-thirds consists of U.S. government or government-guaranteed securities. Because government interest rates have been kept at unusually low levels, retirees and other holders of government bonds receive very low rates of return. Many tax-exempt securities have more attractive yields. And the stocks of many blue-chip companies have dividend yields almost double 10-year Treasury yields. Investors should ensure that their bond portfolios include higher-yielding bonds and to use a dividend growth fund as a partial substitute for what would be an all-bond portfolio during more normal times.

Suppose you already have a portfolio allocation that is internationally diversified and includes safer income-producing investments as well as commercial real estate. As relative market prices have changed over the past two years, your portfolio has probably become unbalanced, with a higher exposure to equities than you originally intended. It's time to rebalance your portfolio by taking some money off the table in the asset class that is now overweighted, putting the money to work in asset classes that have not done as well.

We all wish some genie could tell us when the stock market tops out so we could sell. Rebalancing is the closest technique available to do that. Rebalancing will always reduce the risk level of the portfolio, and over the past 20 years it has also increased portfolio returns.

Rebalancing can often require the realization of capital gains and thus additional taxes. One technique to mitigate the tax consequences is to harvest tax losses in some other part of your portfolio. Suppose you had a loss on an exchange-traded fund portfolio of emerging-market stocks that tracked one specific index. You could swap that ETF for an equivalent one that tracked a slightly different index and realize a capital loss to offset other gains.

A further risk-reduction technique is to create a cash-investment reserve. Putting aside 5% of an investment portfolio in cash should let you sleep a bit better at night. Use a certificate of deposit at an FDIC-insured Internet bank for the reserve and you can earn close to 1% on your cash investment. Don't fool yourself into thinking that you can correctly reinvest the cash reserve in response to short-run swings in market prices. But if there is a severe stock-market decline of 25% (and/or interest rates rise sharply), you could consider putting the money back to work.

Finally, review what you are paying on any individual funds in your portfolio as well as the fees charged by your investment adviser. We are very likely to be in a low-return environment for some time to come, with a broadly diversified portfolio earning no more than 6% a year. If your total expenses are 2% a year, a substantial share of your investment return is consumed by fees.

One way to control fees is to use index funds rather than actively managed investment funds. Every year we are told that the next year will be the one when active management will be rewarded. And every year we are disappointed. In 2014, well over three-quarters of actively managed stock and bond funds were outperformed by low-cost index funds.

You could also consider a computer-based investment adviser if you need professional advice. These advisers can accomplish the diversification, rebalancing, tax-loss harvesting and other portfolio management services you require, and they can do so at fees as low as one quarter of 1%.

Mr. Malkiel, chief investment officer of Wealthfront, is the author of "A Random Walk Down Wall Street" (W.W. Norton). The revised 11th edition will be available next week.