

Financial Life Notes

For your Financial Independence & Peace of Mind
Martin Wealth Management, LLC
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Simplicity – a Common Goal. We are now well into fall and almost everyone I know is incredibly busy. Football games, soccer games, back-to-school activities, and fall lawn clean up keep our weekends full. With such full schedules, I hear a lot of people talking about simplifying their lives. One simplifying step you can take is to simplify your investment portfolio. An investing strategy based on a well-diversified portfolio, with an asset allocation that fits your unique risk profile and goals is central to a successful financial plan. Defining “your” strategy takes a little bit of work, but once you have it defined, following your plan should be a simple task. In this newsletter you will find an interesting article on one aspect of following your plan: rebalancing your investment portfolio. The article was written by fellow Cambridge Advisor, my friend and mentor, Stuart Farnell. Rebalancing is simple and should be part of everyone’s portfolio strategy.

Enjoy the rest of October! If you have any questions, please send me an email at steve.martin@mwm3.com.

Steve

Quote of the Month:

There are hundreds of paths up the mountain,
all leading in the same direction,
so it doesn't matter which path you take.
The only one wasting time is the one
who runs around and around the mountain,
telling everyone that his or her path is wrong.
Hindu teaching

Rebalancing Your Investment Portfolio

By Stewart Farnell, Ph.D., CFP®

Every year the work of financial planning includes a review of your investment portfolio. We compare the actual percentage of each asset class in your portfolio (such as large cap domestic stock, international stock, money market funds) to your target percentage for that class. If you have too much invested in one asset class, we sell enough to bring it back to your target percentage. And if your investments in another asset class fall below your target, we buy enough to bring you back to your target. This is called “rebalancing.”

Rebalancing helps increase your portfolio return while it also reduces risk. A simple example of this is provided by author and investment manager Richard Ferri in his book *All About Index Funds* (McGraw Hill, 2002). Ferri asks us to consider a portfolio made up of only two funds, each making up half of the portfolio.

Fund AA gains 20% the first year and loses 10% the second year for an average annual total return over 2 years of 8%. (A 20% gain in the first year increases AA to 1.2 times what it was to begin with; likewise a 10% loss between the first and second years translates into a balance at the end of the second year that is only 90% of the balance at the end of the first year.) Using real numbers, it looks like this. The position in AA is worth \$1.00 at the start of Year 1 and is worth \$1.20 at the end of Year 1 (\$1.00 to \$1.20 is a 20% gain). So we start Year 2 with \$1.20, suffer a 10% loss (ouch!) and end Year 2 with \$1.08 (\$1.20 to \$1.08 is a 10% loss). Looking at both years together, Fund AA began at \$1.00 (beginning Year 1) and ended at \$1.08 (ending Year 2). So overall there is an 8% gain.

Our other Fund ZZ loses 10% in Year 1 and gains 20% in Year 2, again for an average return over the two years of 8%, but in this case the math is reversed. Starting from an initial value of \$1, a 10% loss in Year 1 means Fund ZZ ends the year at \$0.90. A 20% gain in Year 2 increases ZZ's value to \$1.08 (1.2 x \$0.90). If the portfolio is held for two years and not rebalanced during this time, the combined return of Funds AA and ZZ is 8%, since each fund grew by 8%.

However, if at the end of the first year the portfolio is rebalanced back to its target allocation of 50% in each fund, the return on the portfolio increases from 8% to 10.25%. At the end of Year 1 the portfolio has a 5% gain. (Fund AA gained 20% and constitutes half of the portfolio, so the portfolio as a whole is up 10% due to AA; likewise fund ZZ lost 10%, so the portfolio as a whole lost 5% due to ZZ.) After subtracting the 5% loss from the 10% gain, our portfolio as a whole is up 5%.

Some of the gains from AA are sold (at a profit) and invested in ZZ, sufficient to bring the portfolio back to its 50/50 mix. At the end of Year 2, the portfolio has another 5% gain. (This is the same calculation used above, except that this time it was AA that lost and ZZ that gained.) Over the two-year period, the portfolio has gained 10.25%. (At the end of Year 1 it is worth 1.05 times what it was worth to start with; at the end of year 2 it is worth 1.05 times what it was worth at the end of year 1, or 1.1025; compared to a beginning value of 1, this is a 10.25% gain). Not only has the return of the portfolio increased, but its risk has also been reduced. Because AA was trimmed back to its target 50% level after the first year, there was less in AA to be hit by its subsequent decline in year 2. Rebalancing helps keep the portfolio's risk from rising above its desired level.

Does it matter how often we rebalance the portfolio? Not really. A recent study published by Vanguard's Investment Counseling & Research group showed that annual rebalancing produces results similar to more frequent rebalancings. What matters is that the portfolio is rebalanced—regularly and systematically.

Book Recommendations

For Your Life: "Hard Questions for an Authentic Life" - Written by Susan Piver. One hundred questions to help you explore your deepest beliefs about relationships, friendships, family, work, money, creativity, and spirituality. This is a powerful book that I highly recommend.

For Your Money: "How to ruin your Financial Life" – Written by Ben Stein – An easy read, full of excellent advice written in Ben Stein's typical dry humorous style. By pointing out the many ways people wreck their financial status, he illustrates how to attain a life in which—even if you're not a billionaire—money doesn't keep you up at night. This probably isn't the only financial planning book one should read, but it is entertaining—and it's a surefire shot of reality for anyone heading down the well-worn path to financial ruin.

Investing Quote of the Month:

"One thing is clear: Style drift happens to a sizable percentage of mutual funds...For [investors or] planners seeking to create portfolios tapping into consistently different equity styles, style drift presents a significant concern." Craig L. Israelsen, Ph.D

Steve Martin is President of Martin Wealth Management, LLC, a Fee-Only Financial Planning firm located in Fort Collins, Colorado, and is a Registered Investment Advisor with the State of Colorado.

Martin Wealth Management was founded on the belief that people should use their money to create a fulfilling life – rather than using their life just to create money. Financial Life Planning from Martin Wealth Management begins with this assumption and focuses on your values and dreams. We utilize concepts and processes developed by George Kinder – known as the "Father of Financial Life Planning."

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