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What is portfolio rebalancing?

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WHAT DOES IT MEAN?

Portfolio rebalancing refers to the buying and selling of financial securities (such as bonds, stocks and derivatives) so the composition of the financial asset classes stays the same in one's investment portfolio.

WHY IS IT IMPORTANT?

Portfolio rebalancing is necessary and beneficial for investors in order to enhance their returns.

Portfolio allocation among various financial asset classes determines, to a large extent, the financial returns of the portfolio. Besides the expected return and risk of various asset classes, the optimal portfolio composition is also derived based on the individual investor's preferences.

Thus, different investors could have different optimal portfolio allocation compositions. When the prices of individual securities move significantly, the new asset composition will deviate from the original one. In order to maintain the optimal portfolio allocation, individual securities within each asset class need to be traded, that is, the portfolio needs to be rebalanced.

If a security has performed poorly – for instance, below the expected return – it would be desirable for investors to replace it with a better-performing security within the same asset class.

The process of selecting a new security should be guided by the same investing principle: The expected return should be evaluated together with the underlying risk of the individual securities when they are added to the portfolio.

It is highly recommended that portfolio rebalancing be done at least once a year.

IF YOU WANT TO USE THE TERM, JUST SAY:

"Portfolio rebalancing could help investors to enhance their investment returns."

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