REBALANCE WHEN THE STOCK MARKET BOOMS

When the stock market is booming and your shares are increasing in value all the time, how often do you revisit the balance between your shares, bonds, property and cash investments? If you last reviewed this mix more than two years ago, it is time for a check-up…quickly!

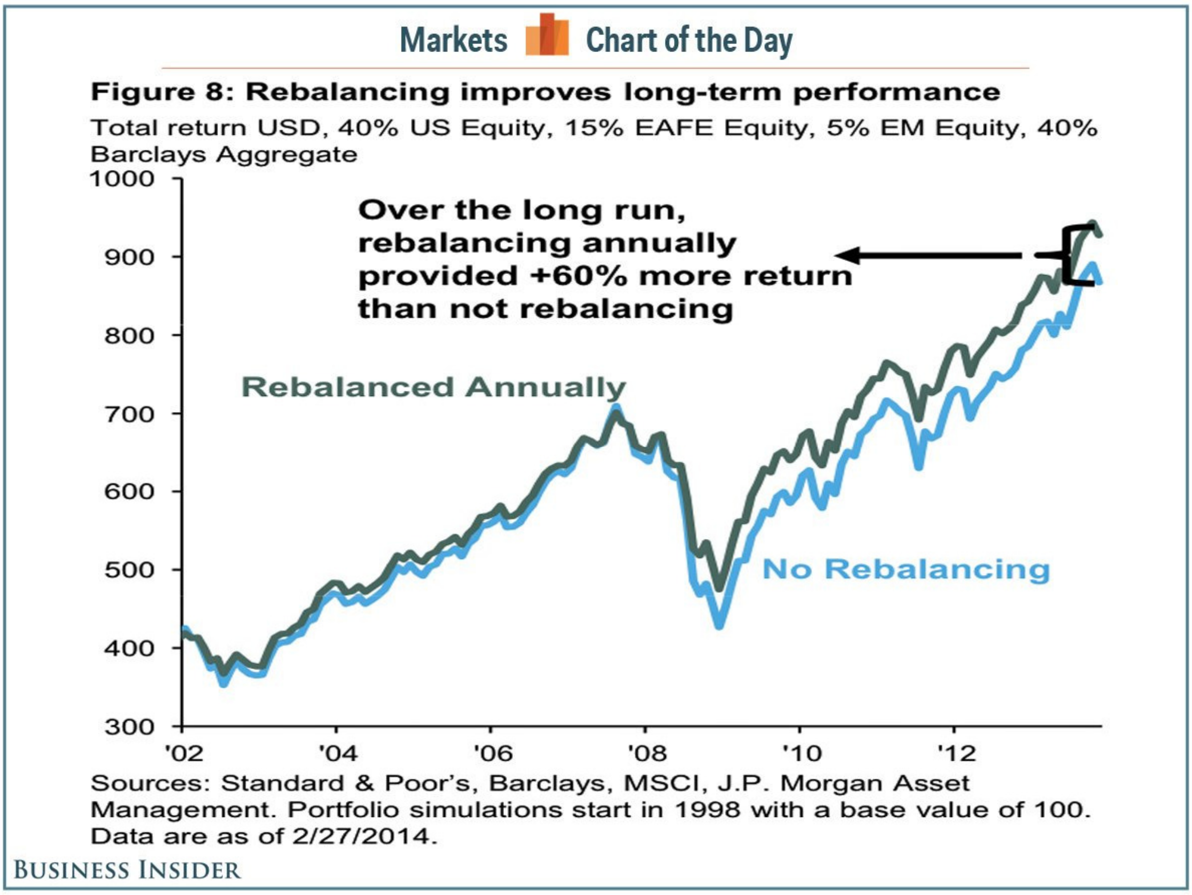
STOCK MARKETS ARE DOING VERY WELL

Over the last 10 years, the South African stock market has grown investors' money by a total of 20% per year. This is an astounding return and is far higher than the normal growth generated by the stock market, in fact, the returns have been 33% higher than you would normally expect over a 10 year period. It should not require any investment genius on your part to realise that this growth is very unlikely to be repeated in the next five years. Does this mean you should sell all your shares now? I think not. Most of the other investment classes are not very attractive at this time; cash is not king, government bonds are not looking rosy and listed property is also facing headwinds from rising interest rates.

If you are a moderate risk investor and started your portfolio in 2009 with 50% of your assets in shares and 50% in bonds, it is likely that you would now have 61% of your assets in shares and only 39% in bonds. If the stock market goes through the same type of crash that we saw in 2008, you could see a loss of capital that is far greater than you can tolerate. This means you need to take proactive but rational action to protect yourself and unfortunately, selling everything and placing it under your mattress or in your savings account is not a good solution.

It is absolutely impossible to predict a stock market crash (until shortly after it is finished) so there is little point in selling out of shares now in anticipation of a crash. The stock market can remain expensive for years, which would mean that you will lose out on all future growth and dividends if you became a cash investor now. A strict regime of rebalancing your asset mix is your best method of protecting yourself against overwhelming losses.

The graph below from Business Insider shows that investors who maintain a disciplined rebalancing strategy will also generate better investment returns over the long term. In this case they rebalanced a portfolio that had 40% in bonds and the balance in global shares on an annual basis from 1998 to now. The rebalanced portfolio still goes up nicely when the stock market does well but it does not fall as far when the stock market drops. This is because a strict rebalancing discipline forces you to automatically sell assets which are more expensive and to buy those that are cheaper. As we know, over long periods of time, you will be a successful investor if you buy cheap assets and sell them once they have become expensive. Automatic rebalancing achieves this objective for you in a rational, sustainable manner.



This type of strategy also helps when stock markets are very expensive (like they are now) because you don't have to second-guess where markets are going in order to decide what to do with your own money. You simply focus on your asset mix to ensure that you have the correct allocation to each type of investment. If the market crashes, you will then be in a position to buy into shares again at a better price because you will have sufficient money in other assets classes like cash and bonds which will now provide the capital to buy shares at a good price.