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U.S. SECURITIES AND EXCHANGE COMMISSION

Asset Allocation, Diversification, and Rebalancing 101

What is asset allocation?

Asset allocation involves dividing your investments among different assets, such as stocks, bonds, and cash. The asset allocation decision is a personal one. The allocation that works best for you changes at different times in your life, depending on how long you have to invest and your ability to tolerate risk.

Factors to consider include your:

Time Horizon. Your time horizon is the number of months, years, or decades you need to invest to achieve your financial goal. Investors with a longer time horizon may feel comfortable taking on riskier or more volatile investments. Those with a shorter time horizon may prefer to take on less risk.

Risk Tolerance (/investing-basics/guiding-principles/assessing-your-risk-tolerance) . Risk tolerance is your ability and willingness to lose some or all of your original investment in exchange for potentially greater returns.

What is diversification?
What is rebalancing?

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The practice of spreading money among different investments to reduce risk is known as diversification. Diversification is a strategy that can be neatly summed up as "Don't put all your eggs in one basket."

One way to diversify is to allocate your investments among different kinds of assets. Historically, stocks, bonds, and cash have not moved up and down at the same time. Factors that may cause one asset class to perform poorly may improve returns for another asset class. People invest in various asset classes in the hope that if one is losing money, the others make up for those losses.

You'll also be better diversified if you spread your investments within each asset class. That means holding a number of different stocks or bonds, and investing in different industry sectors, such as consumer goods, health care, and technology. That way, if one sector is doing poorly, you may offset it with other holdings in sectors that are doing well.

Some investors find it easier to diversify by owning mutual funds. A mutual fund is a company that pools money from many investors and invests the money in stocks, bonds, and other financial products. Mutual funds make it easy for investors to own a small portion of many investments. A total stock market index fund, for example, owns stock in thousands of companies, providing a lot of diversification for one investment.

A mutual fund won't necessarily provide diversification, especially if it focuses on only one industry sector. If you invest in narrowly focused mutual funds, you may need to invest in several to be diversified. As you add more investments to your portfolio, you'll likely pay additional fees and expenses, which will lower your investment returns. So you'll need to consider these costs when deciding the best way to diversify your portfolio.

What is rebalancing?

Rebalancing is what investors do to bring their portfolio back to its original asset allocation mix. Rebalancing is needed because over time, some investments will grow faster than others. This may push your holdings out of alignment with your investment goals. By rebalancing, you will ensure that your portfolio does not overweight a particular asset category, and you'll return your portfolio to a comfortable level of risk.

For example, you might start with 60% of your portfolio invested in stocks, but see that rise to 80% due to market gains. To reestablish your original asset allocation mix, you'll either need to sell some of your stocks or invest in other asset categories.

There are three ways you can rebalance your portfolio:

1. You can sell investments where your holdings are over weighted and use the proceeds to buy investments for underweighted asset categories.
2. You can buy new investments for underweighted asset categories.
3. If you are continuing to add to your investments, you can alter your contributions so that more goes to underweighted asset categories until your portfolio is back into balance.

Before you rebalance your portfolio, you should consider whether the method of rebalancing you decide to use would entail transaction fees or tax consequences. Your financial professional or tax adviser can help you identify ways that you can minimize these potential costs.

Some financial experts advise rebalancing at regular intervals, such as every six or 12 months. Others recommend rebalancing when your holdings of an asset class increase or decrease more than a certain pre-set percentage. In either case, rebalancing tends to work best when done on a relatively infrequent basis.

Shifting money away from an asset class when it is doing well in favor of an asset category that is doing poorly may not be easy. But it can be a wise move. By cutting back on current “winners” and adding more current “losers,” rebalancing forces you to buy low and sell high.