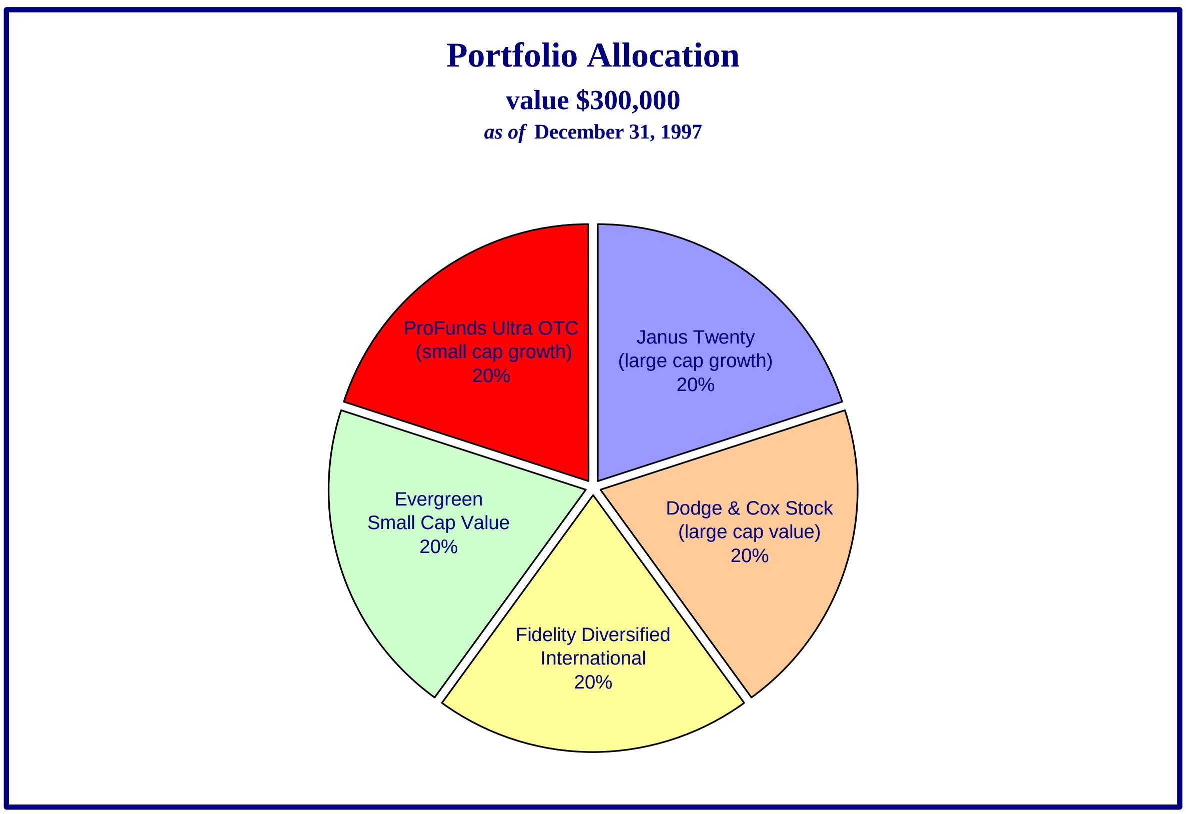
Why We Rebalance a Portfolio

Great lesson – still relevant!

Rebalancing a portfolio seems to make sense. That is, until the investor realizes that in order to rebalance an investment portfolio, he is going to sell a portion of the funds that have been performing well, maybe incredibly well. In fact, the better the funds perform, the more of their shares that will need to be sold. With those sale proceeds, the investor will purchase additional shares in the funds that have not been performing as well, maybe funds that are losing money. In fact, the worse the funds perform, the more of their shares will need to be purchased. When looked at in these real life terms, it is a wonder any investor agrees to rebalance a portfolio. Doesn't common sense, and a lot of emotion, suggest that the funds that are performing poorly be liquidated and reinvested into the momentum of the better performing funds?

We created a real life equity portfolio to show why rebalancing makes a whole lot of sense. Here is the year-end 1997 makeup of the portfolio that we thankfully never owned:



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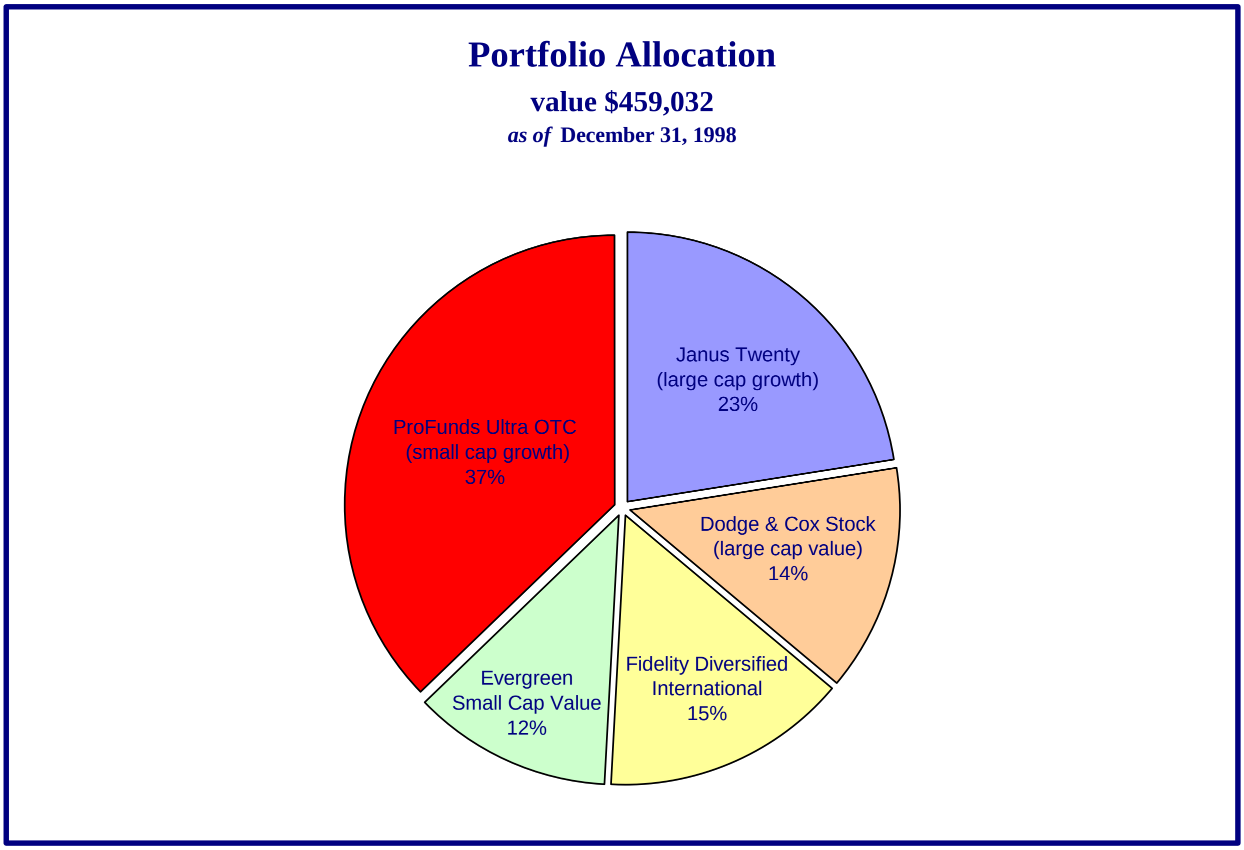
One year later, the makeup of the portfolio had naturally changed:



The portfolio had grown by 53%, in large part as a result of the impressive growth of ProFunds Ultra OTC (UOPIX) which had grown to represent 37% of the un-rebalanced portfolio. Getting the investor to sell some of the Profunds Ultra OTC to rebalance the portfolio was a hard sell.

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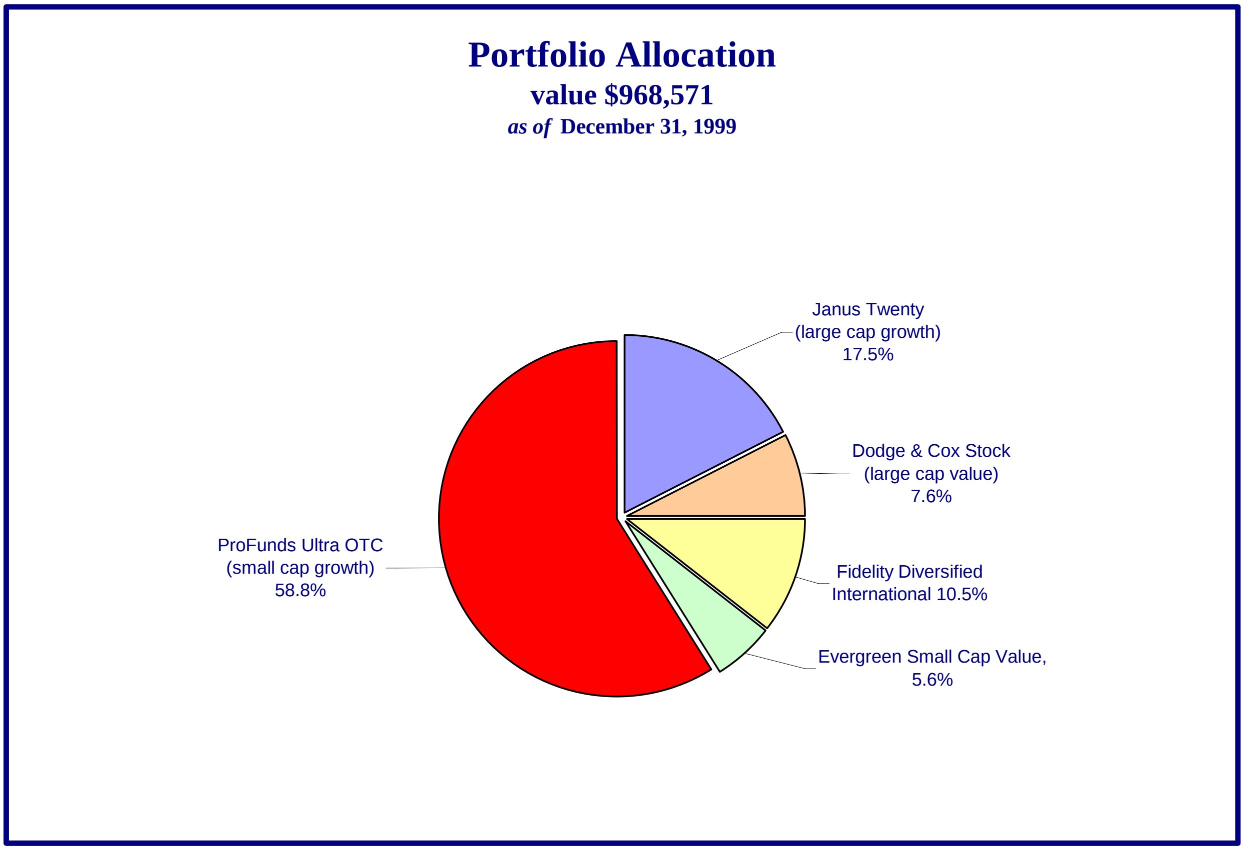
Now look at the portfolio at year end 1999. It had grown by a whopping 223%. In hindsight, rebalancing did not seem like such a good idea. But ProFunds Ultra OTC was now controlling almost 60% of the portfolio's future.



It took all the discipline the investor could gather just to keep from selling every share of the other funds in the portfolio and moving the proceeds into ProFunds Ultra OTC before it was too late. After all, a $300,000 portfolio that had grown to be worth $968,571 in only 24 months was nice, but if the entire $300,000 had been invested in ProFunds OTC back in 1997, the one fund portfolio would now be worth $2,852,577. Don't for a minute think that thought had not crossed the investor's mind. So much for rebalancing!

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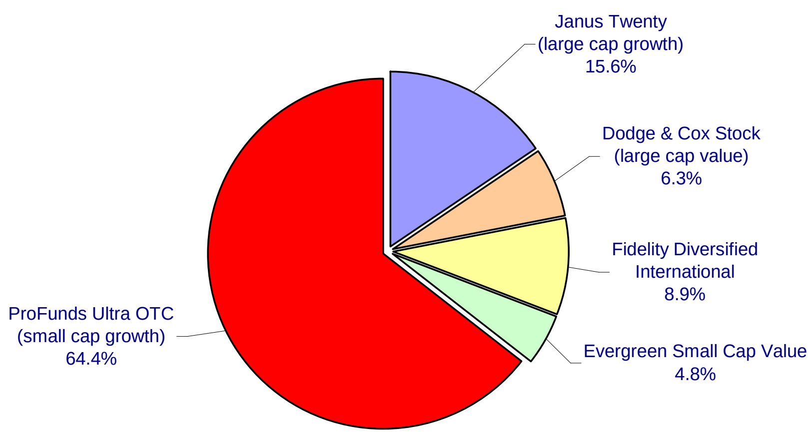
Let us move forward to March of 2000 — the top of the market. The investor was in a state of euphoria over his portfolio. In a span of 27 months, the investor's portfolio had grown 283% from the original December 1997 value of $300,000 to a mind boggling $1,148,606. He was kicking himself for not putting all $300,000 into ProFunds Ultra OTC. He was again using hindsight to figure that his portfolio would have been worth $3,699,112 if it had consisted of one holding — ProFunds Ultra OTC. In spite of the fact that the fund now represented two-thirds of the portfolio, conversation about rebalancing would prove fruitless.

Portfolio Allocation

value $1,148,606

***as of* March 31, 2000**



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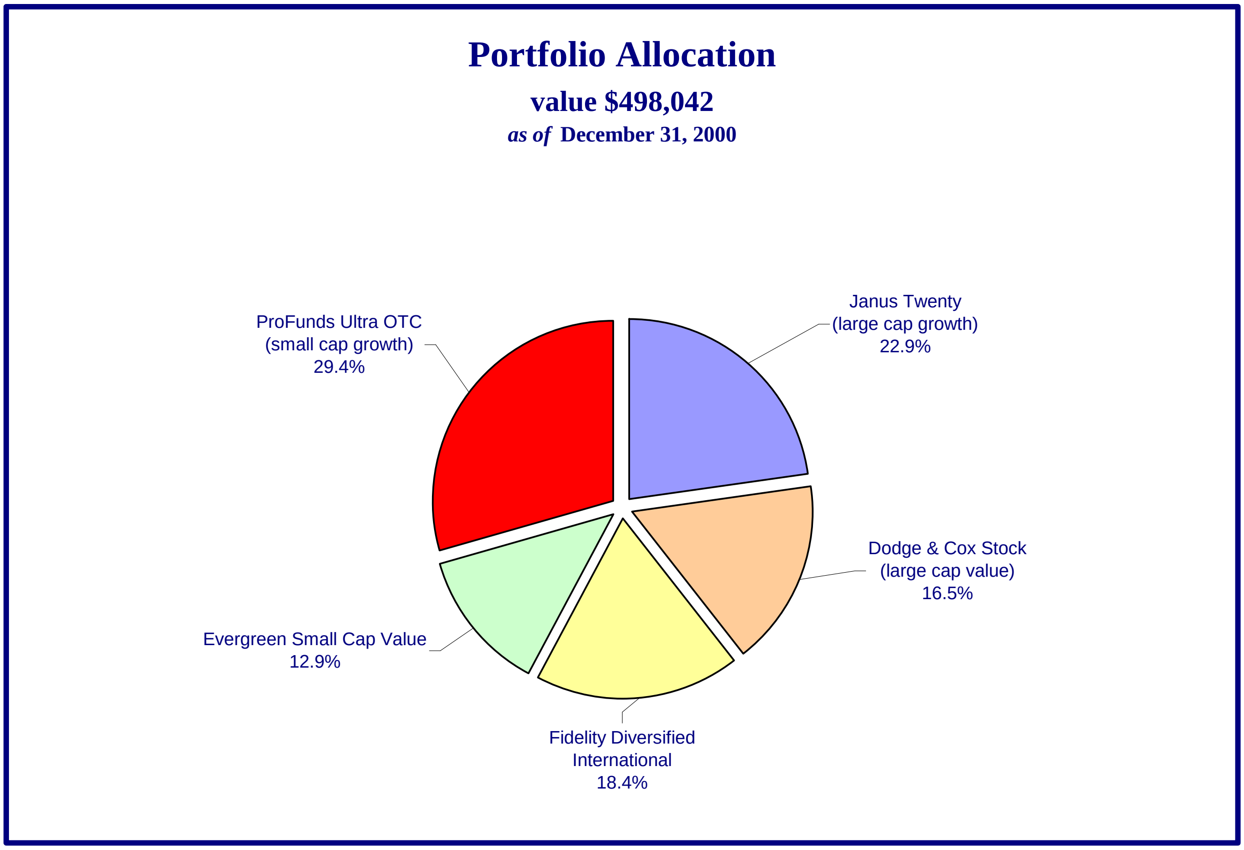
Before the investor knew what hit him, it was December 2000 and the market had begun a serious correction — especially ProFunds Ultra OTC. The million dollar portfolio had lost 57% of its value, led by ProFunds Ultra OTC. Ironically, rebalancing was taking place — the hard way.



To add insult to injury, while the portfolio lost over $470,000 in 2000, the investor still received a taxable 1099 statement totaling for over $40,000 in capital gains!

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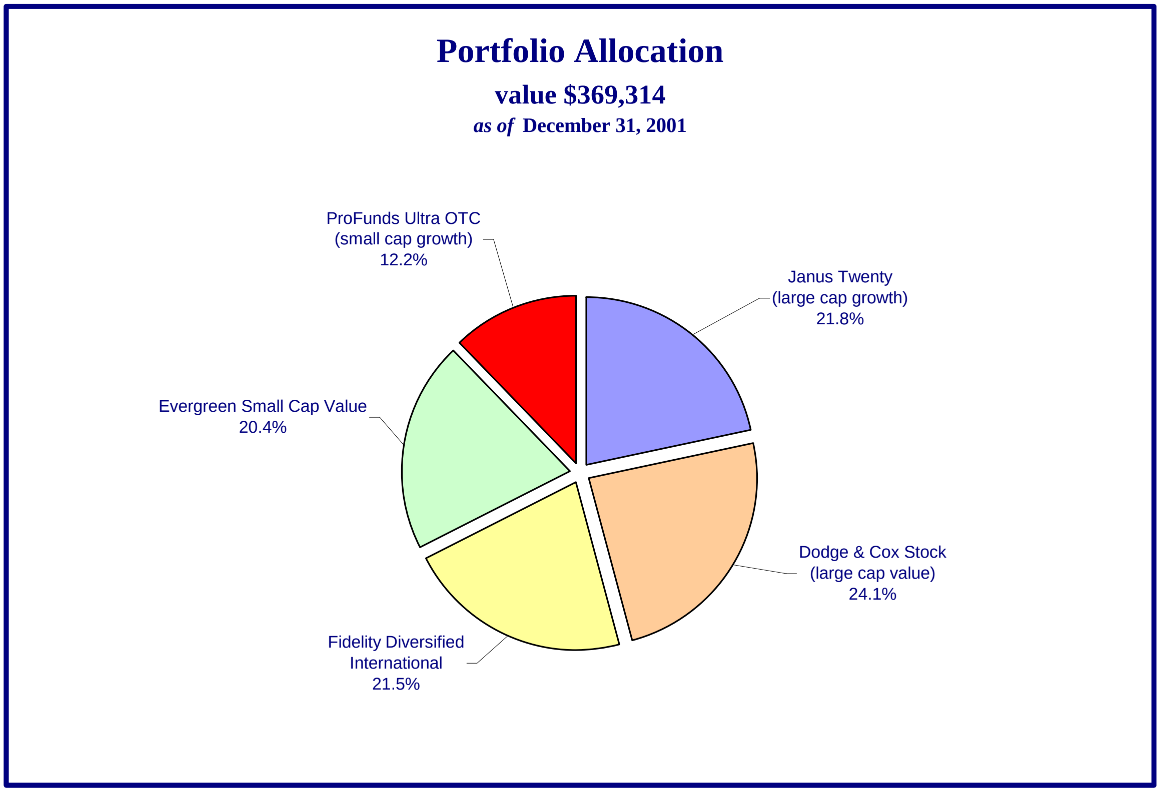
The investor might have been disillusioned, but he was not ready to sell ProFunds Ultra OTC. After all, this fund had been such a darling. Besides, the year-end statement from the fund had arrived. We assume it probably claimed that the worst was probably over. Before parting with ProFunds Ultra OTC, the investor decided to recoup some of the fund's losses first. Remember too, the investor was not interested in the fact that his $300,000 investment had grown to an impressive $469,488 in just 36 months. He looked at the situation the way most investors do. He was down over $650,000 since March 2000, and he intended to get it back.

A year later . . .



Due to the total collapse of ProFunds Ultra OTC, the investor lost 68% of his March 2000 portfolio value. Had he chosen to rebalance annually along the way, things would have worked out better financially, and a whole lot better emotionally. While the portfolio would not have reached the $1,148,606 mark in March 2000, it would have grown to an impressive $785,736; however, more importantly, the portfolio would not have fallen back to a December 2001 value of $369,314. Instead, it would have produced a most satisfying portfolio value of $510,906.

While this example might be extreme, it can happen. It did happen. Rebalancing works!