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In-The-Know Monthly eNewsletter

Rebalancing Thrift - Is it Really Necessary?
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By now everyone has gotten the message that the Thrift Savings Plan is the best deal in town. Where else can you invest with the ease of payroll deduction at such an incredibly low cost, *and* get valuable tax deductions (if you use the Traditional rather than Roth option) *and* get some of your contribution matched if you're in the newer retirement plans, *and* defer or eliminate the income tax liability on any interest, dividends and capital gains? Really, that's as good as investing gets. You have also heard that by giving some attention to the allocation of your funds and by using the stock funds, it has been possible to grow the balance to $1M or more over the course of a career. Not a bad way to feel confident about retirement. Picking the right allocation is pretty straightforward, as well, since there are really only a handful of choices. Think about how long it will be before you start spending your TSP money - the more time you have the more you consider stocks (C, S and I Funds). Then be honest about your temperament - the more nervous you get the more you consider "thou shalt not panic" money in G and sometimes F. A little time on the www.tsp.gov site and you're typically good to go either with an allocation mix of your own design or a professionally designed L Fund.

Once you're committed to making contributions and you've selected the right allocation of funds to meet your needs, the next step to a successful TSP account is making decisions about rebalancing. Rebalancing can play a crucial role in investment management. For one, it keeps the overall risk in the portfolio from drifting higher. Since riskier investments can outperform more conservative investments, the whole portfolio becomes riskier when the markets are moving upward. If a portfolio was allocated 50% Stocks, 40% Bonds and 10% Cash in December 1992, without rebalancing it drifted to 62.3% Stock, 33.6% Bonds and only 4.64% Cash by the end of 2012. Nobody minds the heavier position in stocks while the market is climbing. But, when prices begin to fall, the stock will likely fall further and faster than the bonds and cash and the investor experiences more risk than they intended. The other reason to rebalance is to potentially take advantage of the sell-high, buy-low opportunities. If one fund has had an extremely good year relative to the others, reducing the "winner" and adding the proceeds to the lower performing fund can actually preserve the gain while managing risk. Of course, this assumes the lower performing fund is going to eventually have better returns and you really have to be paying attention to spot these opportunities. Here's a helpful observation: If you simply keep your contributions buying into the market, even when the values are dropping, you're essentially getting the advantage of "buying low" without being an experienced professional.

The big question is how often you should rebalance and it's so big the professionals are still debating it. You'll often see portfolios rebalanced systematically according the calendar - once a month, once a quarter or once a year, for example. It's tempting to think that more must be better. Maybe not. In a recent paper released by Vanguard, "Best Practices for Rebalancing", they looked at data going all the way back to 1926 using a 60/40 stocks to bonds portfolio and compared the effectiveness of these three rebalancing intervals. The research concluded that all three methods kept the portfolio risk from drifting but that more frequent rebalancing did not produce superior results. Ok, that's good to know, especially for those who haven't settled on a rebalancing system.

Beyond the calendar method, there's another approach to rebalancing that may be useful. Let's start with a totally hypothetical TSP that is split 50/50 between C (stocks) and F (bonds) just to illustrate the concept. Rather than rebalance according to the calendar, consider rebalancing only if the allocation has moved too far away (10%, for example} from the desired 50/50. A 52/48 mix doesn't warrant any action, but 60/40, stocks outperforming bonds would be enough drift for you to find your PIN number and do an inter-fund transfer out of C and into F to get back to the desired 50/50. It might be three months, it might be three years before you rebalance, but you still did a good job of managing risk. Note, allocations are always based on percentages, not dollar amounts. This distinction is important. We're not rebalancing merely because of an increase or decline in value, but rather we're looking at relative performance, in this case between C and F.

Remember, the most important reason to rebalance is to make sure your account doesn't drift into a more aggressive position than you can tolerate. That often leads to "panic selling" when the market corrects - you might call that "crashes". Clearly, not a good way to make your TSP grow. Not sure you're up to the task? Pick an L Fund - they are constantly rebalancing which completely eliminates market drift risk. All you have to keep an eye on is the amount in G - it will increase over time and you may have to move to another L Fund with a later target date to keep your funds growing adequately. And finally, all this rebalancing really takes on more importance as you get closer to spending the money. The closer you are to taking withdrawals, the more you need to get serious about managing risk. Good news, once you find the allocation that meets your needs, monitoring your account and occasionally rebalancing is all it takes.

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