The Boston Globe Business

With taxes done, turn attention to investment portfolios

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As stocks gain in value, investors should take the time to rebalance their portfolios.

You've finished your tax returns, but don't stop now. With the stock market's upward march prompting concerns about a correction, it's a good time to take a look at your investment portfolio. And that newly completed tax return can provide some helpful guidance.

Tax preparation forces people to think about their finances, says fee-only financial planner Dana Levit of Paragon Financial Advisors in Newton. That means they've now got a good start at not only projecting their 2014 income, but also focusing on where they've got their money invested.

The first task in any portfolio tuneup is looking at asset allocation. Folks who have had their portfolios on autopilot will likely be surprised to see what a rising stock market has done to their investments. Stocks have roughly doubled in the last five years, with the Standard & Poor's 500 jumping 30 percent last year alone. So many people likely have a higher percentage of stock in their portfolios than they originally planned.

For example, a conservative "sleep tight" portfolio originally designed to be 50 percent in stock and 50 percent in fixed income investments may have gradually shifted toward a 60/40 allocation over the past two years. And those who haven't made portfolio changes in five years might be edging closer to 70/30.

That means many portfolios are carrying a lot of unintended risk. If the current five-year bull market suddenly takes a downward turn, increased exposure to stock would mean a much larger hit. As Levit points out, market cycles tend to produce a downturn roughly every five years, even for portfolios split equally between stocks and bonds.

That's why financial planners typically recommend once-a-year rebalancing. The idea is for investors to move money out of overweighted sectors and into underperforming ones. Yet it takes discipline to rebalance, particularly when stocks are climbing and bonds are yielding at best 2 or 3 percent.

"It is counterintuitive to pull back on an area that has been doing really well," says Judith Ward, a senior financial planner and vice president at investment firm T. Rowe Price. The discipline of rebalancing, however, enforces the practice of selling high and buying low, she says. And that translates into more consistent returns over time.

Rebalancing applies not only to the basic split between stocks and bonds, but also the kinds of investments held within each of these classes. For example, both small cap and large cap US stocks had spectacular performances last year, each gaining more than 30 percent. That means these stocks may now be overrepresented in your portfolio. On the other hand, emerging market stocks and bonds fared poorly.

A quick look at the Callan Periodic Table of Investment Returns, which shows annual returns for key indices over the last 20 years, illustrates the volatility of these market sectors. While emerging market stocks, as represented by the Morgan Stanley Capital International Emerging Markets Index, were 2013's worst performer, they were top of the heap in 2012. The small-cap Russell 2000 Growth Index, which was 2013's top performer, was near the bottom a year earlier. And today's out-of-favor bonds have been the top performer twice in the past six years.

"It is amazing how these asset classes can flip so quickly. We have no idea what is going to happen," says Ward. Rebalancing, which moves funds into underperforming areas, helps to position investors to catch the next hot sector.

Fixed income investments, such as bonds, should get the same scrutiny. Fee-only financial planner Jill Boynton of Cornerstone Financial Planning in Newington, N.H., says she's keeping her clients' bond investments in a mix of holdings. Given the threat of both rising rates and inflation, Boynton's current allocation is 35 to 40 percent in short- and intermediate-term bond funds, with the remaining fixed income portfolio split between emerging market, mortgage-backed Ginnie Mae, high-yield, and "go-anywhere" bond funds that can invest in any part of the market.

One way to make rebalancing less painful is to use routine financial transactions to make the shifts. If you've got a stock-heavy portfolio, you may want to put your 2014 IRA contribution into fixed income. Or if you are retired and must take minimum distributions from your retirement accounts, withdraw that money from overweighted sectors.

As part of your portfolio tuneup, use your 2013 return to see how you were affected by the thresholds for higher tax rates and phased-out deductions and exemptions that went into effect last year. If you found yourself bumped into a higher tax bracket, facing the new 3.8 percent tax on net investment income, or losing tax breaks, you may want to shift your investment mix to trim your income numbers.

You might, for example, invest in tax-free municipal bonds instead of taxable bonds. If you want to own taxable bonds, consider holding them in tax-advantaged retirement accounts, using your taxable accounts for stock investments that are taxed at lower capital gains rates. And if your rebalancing strategy calls for you to sell at a gain, look for portfolio losses that can be used to offset those gains.

While you’re at it, make sure to tackle other financial tasks that typically get put on the back burner, says Deborah Levenson, a fee-only financial planner with Braver Wealth Management in Needham. Make sure the beneficiary designations on your retirement accounts are up to date, start organizing your tax files for next April’s returns, use tax refund money to pay off debt, and make your IRA contributions for 2014.