

Rebalancing Investments Can Turn Losers Into Winners, CU Prof Says

May 21 2010

(PhysOrg.com) -- When it comes to investing money in the stock market, actively rebalancing your portfolio is so critical that it can help turn individual investment losers into winners, according to University of Colorado at Boulder Professor Michael Stutzer.

In a recent paper he showed that using a rebalancing investment strategy could resolve a "Parrondo Paradox," a phenomenon in [game theory](#) in which "given two games, each with a higher probability of losing than winning, it is possible to construct a winning strategy by playing the games alternately."

In the paper titled "The Paradox of [Diversification](#)," Stutzer demonstrated a scenario in which two investments were each more likely to lose real income than to earn it. However, creating an equally weighted portfolio of the two, maintained by rebalancing, was surprisingly more likely to earn real income than to lose it.

"Most people think diversification pays because it just lowers the volatility of your portfolio," said Stutzer, a professor of finance and director of the Richard M. Burrige Center for Securities Analysis and Valuation at the Leeds School of Business. "What this shows is that diversification is such a powerful force that you can take investments that on average would lose [money](#) on their own and by diversifying them you have a better chance of making money than losing it."

Many investors initially create balanced portfolios but then fail to

reallocate their funds to keep them balanced. In a buy and hold strategy, an investor may originally have a diversified portfolio, Stutzer said, but then fail to redistribute over time as the values increase and decrease. A rebalanced investment strategy requires repeated action by the investor or the investor's portfolio manager.

For example, suppose an investor puts 60 percent of his or her money in a diversified stock fund and 40 percent in a bond fund. If the stock market goes up by 20 percent next year, but bonds stay even, the investor's portfolio is no longer balanced, Stutzer said. To rebalance the [portfolio](#), the investor would have to sell some of the stock fund, moving that money over into the bond fund to achieve the initial 60-40 mix.

"The part that many investors find hard to follow is reallocating their money," Stutzer said. "It's tough because it means withdrawing money from funds that have soared last year, and adding money to funds that declined last year."

"I think the real take-home message here is just how important it is to keep your investments diversified," Stutzer said. "Rebalancing them can be more helpful than you realized."

Provided by University of Colorado at Boulder

Citation: Rebalancing Investments Can Turn Losers Into Winners, CU Prof Says (2010, May 21) retrieved 25 April 2024 from

<https://phys.org/news/2010-05-rebalancing-investments-losers-winners-cu.html>

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