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Hello and welcome to the Dividend Cafe. I'm your host, David Bahnsen. Today we're going to just be in this pure classic investment mode, talking about a pure classic investment technique and tool, and one I believe in with every ounce of breath in my body. That tool is what our practice just got done doing this week: rebalancing.

We are currently managing about \$9 billion in client capital, and this week we effected a rebalance. It actually lasted about six trading days because of the sheer size and scale of it. That resulted in something in the range of \$530 million of buy transactions and \$630 million of sell transactions.

Because of us just going through this annual regimen, it was topical for me to address the subject for clients, but also all non-client investors that are listening, watching, and reading the Dividend Cafe, as to why rebalancing exists. I remain stunned, 26 years into my professional life of managing money, that there are advisors who do not do this and that there are investors who do not want it done.

I believe it represents one of the easiest and most, shall we say, elegant ways of optimizing a risk-reward relationship for investors that's ever been invented. What exactly are we referring to? Well, listen, when you talk about rebalancing, I want to position this as something that we believe is primarily a powerful risk mitigation tool.

We do believe it is a potential return enhancer. I'm going to talk to you today as to why I believe its return enhancement is actually a byproduct of something behavioral, more than mathematical or portfolio-oriented. And then, thirdly, it's an exercise in humility, and we're going to explain what I mean by that.

I think those who do not rebalance largely have a contempt for risk management, largely have a hubris that they do not deem it necessary, but also operate from an implicit belief that what goes up will always and forever continue going up. Unfortunately, history has not been kind to that belief system.

But what are we talking about when we talk about rebalancing? Just to use some simple, garden-variety math, you may have a stock that was 2.5% of the stock portfolio, and it has gone up to 3% of the portfolio because it's moved up more than others have moved up. Rebalancing is trimming it back down to 2.5%.

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And then, of course, inversely, you may have a stock that was 2.5% and it is now 2% because it's moving down, or moving down relative to the way others have moved up. So there are moving parts, but that part of the math is very simple. Rebalancing is a way of essentially trimming things that are above their target weight and adding to things that are below their target weight.

And what it is not doing is stating that the target weights themselves are correct. The target weights are a byproduct of the portfolio construction process. So there is a different conversation one could have if a portfolio was not allocated correctly to begin with, or if a portfolio manager within an asset class doesn't have a rhyme or reason for what the weightings may be.

But to the extent one has a strategic reason for the asset allocation of the portfolio, and to the extent one has a strategic reason for the weightings of how securities within an asset class are allocated, how they're weighted, then rebalancing is simply restoring that risk-reward relationship—restoring a portfolio to its proper place.

Now, I want to put a chart up right now that is a table of investment returns in terms of the various primary asset classes. We're not right now looking at, like within large-cap growth, what stock A, B, and C may be, or within large-cap growth what part is weighted to energy versus technology.

We're talking about the major asset classes: large-cap stocks, bonds, real estate, emerging markets, small cap, large-cap international value—all these major categories. And what you see as this sticks up on your screen for a bit is something that, if we were like right now, you might be looking at it not able to see the numbers.

And that's a good thing, and I'll tell you why. And you might not be able to see the words, and that's a good thing, and I'll tell you why. Because just the mere color diversity and the pattern of up and down—it could be up a few years and down a few years—and the sort of randomness that would appear to the sequence of returns is enough to illustrate the point without even the specificity of what asset class returned what in what year.

What you see, just by color scheme, is the fact that asset classes over time with positive rates of return and positive expected rates of return have periods of being in favor and periods of being out of favor. If one were to look at how large-cap growth did in the late 1990s, you would say it was at the top every year. You know, how great.

And then you look at the beginning part of the 2000s and see large-cap growth down over and over again. The difference between rebalancing along the way—even if it didn't seem attractive

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at the time because of the strong momentum and performance—and what type of risk mitigation that affected is meaningful.

Likewise, right now you see large-cap growth up at the top. It's up five of the last six years, up over 18%, and maybe someone just believes it will always do that. I wouldn't want to enter into such an argument, if that's okay.

My point here is you can love asset classes on this chart or dislike them, but you have to acknowledge that there is a sense in which various asset classes that all have positive expected rates of return—or they would not be asset classes—over periods of time have seasons of being in favor and seasons of being out of favor. Rebalancing is a way of acknowledging that.

And rooting a portfolio to an allocation that makes sense for a particular investor—that allocation was constructed around one's own liquidity needs, income goals, future income goals, return aspirations, tax ramifications, and a variety of circumstances—but then also, two, the tolerance and comfort with volatility.

Because if one said, "All I care about is maximizing return for infinity," then all you would do is take the asset class with the highest expected rate of return and put 100% there. And you say, "Well, I don't know what the asset class return will be." Well, that's the whole point. You also don't know it after two years of one being really good or five years of one being really good.

That's the purpose of some form of diversification, and therefore rebalancing is a way of restoring to the proper blend of these things that meets the tailored goals of a given investor.

Now, I'm going to put another chart up here that is not the diversification of asset classes, but the diversification of sectors within the S&P 500. So let's call this large-cap U.S. equities. And again, you can see technology and communication services at the bottom of the pack in 2000 and 2006.

People that were rebalancing into that really benefited when it began to recover. And then you see how incredibly strong it's been here over the last several years. But you also see a significant randomness to the color scheme, as some things are in favor at one point and out of favor at another.

It can be very tempting not to rebalance if you think something is permanently affixed to the top of this chart. But the inevitability of this movement is why rebalancing the weightings of your equity exposures is such a prudent idea.

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I also want to point out—I’m not trying to be condescending about math here—but some will say, “Well, look, let’s say I have 20% of my portfolio allocated to a certain thing, and it’s up 20% per year for five years. By rebalancing each year, I’m leaving money on the table because that compounding is being limited.”

Well, that’s absolutely true. It is not true that you’ve eliminated the exposure. You still have 20% of your portfolio in that hypothetical earning 20% per year. It just didn’t earn 22% per year or 26%. It limited some of the upside, but maintained a very healthy exposure, which was the exposure you intended to have with a 20% weighting to begin with.

What did you get in exchange for limiting that upside? You mitigated away a risk that is far more severe, which is one particular year. If you have a 37% correction, it’s 37% of a 20% weighting, not something that’s grown to a 40% weighting.

You can do the math on that. It’s not hypothetical. It’s not just something that makes sense in a spreadsheet. It happens over and over again where the benefits of rebalancing surface.

Of course, rebalancing is unnecessary if you just have the crystal ball. We’ll put the chart back up here real quick of the sectors. If you have the crystal ball right now of what box is going to be best and what’s going to be worst when, and you can time your way in and out, you don’t need to rebalance.

The acknowledgement—whether it was the asset class chart we looked at before or the sector chart here—that at both the high-level building blocks of a portfolio and at the individual sectors within a portfolio, because one doesn’t have that crystal ball, the humility of recognizing the lack of perfect prescience around these things makes rebalancing a very wonderful tool.

The issue at play is risk appetite and comfort level. If something is deemed to be appropriate at a 20% weight in a portfolio and it grows to 30% or 40%, then rebalancing it down to 20% is done because you didn’t change.

Now, maybe you did. Maybe you said, “No, I inherited new money. I now have a higher risk appetite.” Or some other internal reality makes it appropriate. That’s for the advisor who’s doing their job to customize the portfolio around a change in circumstances.

But if you say, “Well, I didn’t change, but the market’s up and I just really like this because it keeps going up,” that is not a healthy way to formulate a risk appetite. It is rear-view mirror investing. It is the fallacious assumption that what just happened is bound to happen again.

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To me, not rebalancing is an implicit admission that either the portfolio was constructed poorly or one doesn't believe in the tenets of how it was constructed—that they're making an exception to what they said they believe around market circumstances. It becomes a form of market timing that skews things.

Now, why do I care? Why does this matter? It is fundamentally an issue of behavioral management. At the end of the day, the math of saying the more of your portfolio weighted to the highest-performing asset class, the better, is very good math.

If you have one asset class that's going to make 10% and one that's going to make 5%, a portfolio with 100% in the one making 10% will do better than one with 80% in the one making 10% and 20% in the one making 5%.

So why does anybody put asset classes they expect a lower rate of return from into a portfolio alongside asset classes they expect a higher rate of return from?

You look at it from the vantage point of The Bahnsen Group. There's a link in the midst of our Dividend Cafe article that goes to our website where it lists all the different categories we invest around, because we're not real generic, vanilla style-box investors. We've created customized building blocks—what we call Operation Magnify—around how we put together a holistic client portfolio.

Everybody knows dividend growth is our bread and butter. It's the asset class I believe has optimal risk-reward characteristics: liquidity, tax efficiency, the ability to achieve growth, the ability to achieve income, and the ability to achieve growth of income, all rolled into one.

In a perfect world, with infinity as a timeline, I would love dividend growth as 100% of a weighting. But why do we implement various things such as illiquids or alternatives or fixed—or boring—bonds?

The reality is that on an individual basis, you might be doing things to put higher levels of volatility in place for income or growth enhancements, or largely to limit volatility through the use of other asset classes that you expect to diversify away from equity market volatility. And those things come at a cost.

The notion that we want to have things with lower returns in the portfolio is not irrational, as long as you understand why you're doing it. It's because you're trying to keep yourself within a comfort level that avoids you abandoning the portfolio that contains the higher-return asset classes.

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You can't get that return if you're not in it. And if you sell out of it because of discomfort from volatility, you don't get the return. You don't reap the benefits. Keeping someone on the ship is the goal of asset allocation.

The question, then, from a rebalancing standpoint, is whether we're doing it to enhance returns or reduce risk. My answer is that I don't think they're separable from one another.

If someone has a comfort level of 60% equities and it grows to 85% because of a screaming bull market, then what happens when stocks drop 30%? At 60%, that was something they said they could handle. At 80% or 85%, that same drop now does exactly what they said they were afraid of.

So you've called into question sustainability—your likelihood of achieving the returns of the very asset classes you're invested in. Rebalancing enables one to stay aligned with their goals and comfort level. It is a governor on human psychology.

No one can benefit from equities they do not own. And most people will not own equities, including great dividend growth ones, if downside volatility causes them to jump off the boat. We capture more upside by minimizing those who jump off the boat, and we do that through asset allocation and rebalancing.

Even if one does have 100% weighted to dividend growth equities, rebalancing still matters. It's no longer about stocks versus bonds, but about trimming stocks that outperform and adding to those that underperform within a diversified equity portfolio.

If the thesis is still there—the long-term case for value creation, dividend sustainability—then buying more at lower prices is beneficial. This becomes a buy-low, sell-high automation. It becomes systematic and non-emotional, and non-emotional decisions generally make for better investor outcomes.

Finally, some will argue, "What about taxes?" Yes, trimming gains realizes capital gains in taxable accounts. This doesn't apply to IRAs, 401(k)s, and other non-taxable accounts.

But I never believe in letting the tax tail wag the investment dog. In fact, I'd argue it's a feature, not a bug. If you never trim and face one massive gain later, the tax and psychological hurdle becomes much larger.

Mitigating that along the way through annual trimming still has tax consequences, but they're smaller and psychologically easier to manage. That makes it easier to do the right thing.

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Rebalancing isn't hard. It isn't new. It isn't complicated. What it does is go against human nature—greed when things are good and aversion to buying underperformers.

But over time, as risk is reduced and behavior improves through systematic rebalancing, we believe it's almost free money—almost a gift to investors.

We'll do it for the rest of our days. I appreciate you allowing me to go into this evergreen topic of portfolio rebalancing. I look forward to coming back next week in the month of February. January has flown by.

In the meantime, thank you for listening, thank you for watching, and thank you for reading the Dividend Cafe.