

Tactical Asset Allocation

James Dykstal, CFA

Through the brutal bear market of 2008 investment portfolios struggled and traditional diversification did not help as correlations of most asset classes moved together.

Institutional investors are now concerned that equities will have lower than average returns over the next decade. They are looking to different strategies to enhance return and are adopting forms of tactical asset allocation.

Tactical asset allocation (TAA) is a dynamic shift of assets between broad asset classes done with the intent to reduce risk or enhance return. The ability of TAA practitioners to shift between asset classes better enables them to navigate turbulent economic waters.

TAA works because it shifts allocation between asset classes counter-intuitively to typical human behavior.

Most funds have strategic asset allocation ranges to meet long-term fund objectives and liabilities. The underlying belief is that asset classes will have returns similar to long-term asset class returns and risks. But history tells us that markets seldom return the average return but will enter into long term bull or bear market cycles which result in the average. Tactical asset allocation is a method of adjusting the asset mix to capture opportunities for higher returns or lower risks based on current expectations, rather than expected long-term averages. Many investors give managers wide latitude in asset class ranges, but the ranges are seldom utilized. In this new environment, active asset allocation using a disciplined approach makes sense.

This re-thinking of asset allocation is not new. In 2004, Arnott discussed that the static model of asset allocation needs to be rethought: “It’s time to rethink the ways we define and use policy portfolios. Those who do so, rather than those following the pack, may even find an opportunity to outperform as the world moves toward a more balanced view of investment risk.” (“The Policy Portfolio Problem”, Financial Analysts Journal, 2004). Arnott had expanded on Bernstein’s *Points of Inflection*, (“Points of

Tactical asset allocation is a method of adjusting the asset mix to capture opportunities for higher returns or lower risks based on current expectations, rather than expected long-term averages.

Inflection: Investment Management Tomorrow” July/August 2003, The Financial Analysts Journal).

Under the old model of asset allocation, excess return is hoped for by active management by managers in each asset class. Investors are compensated for bearing market risk such as changes in interest rates, inflation, business cycles and so forth. Each active manager hopes to add return by picking a better stock or bond. Investors have been reluctant to engage in TAA as it is perceived as hard to do but now realize it as one of the few ways to add more value to a portfolio than just security selection alone.

TAA adds value by overweighting asset classes that are expected to outperform and underweighting sector expected to underperform. Portfolio construction not only reflects client goals but also the current market outlook. The traditional asset classes of stocks, bonds and cash can be broken down to sub-asset classes such as growth and value stocks, international and emerging market stocks, large capitalization and small capitalization stocks or corporate and Treasury bonds.

The underlying theory of TAA is that relative returns among asset classes will diverge from long run averages. As prices rise, it is human nature to put more money into that asset class. The argument for tactical asset allocation is that people do tend to “buy high and sell low” and recent research shows that people pay far too much attention to the most recent price movements (“Tactical Asset Allocation”, William Goodsall, AIMR). Instead exposure to an asset class that has done exceptionally well should be pared back.

The underlying theory of TAA is that relative returns among asset classes will diverge from long run averages.

In the 1800s, classical economists adopted the rational decision making hypothesis under the assumption that humans are rational, unemotional beings. This ignores human behavior. TAA works because it utilizes a rational process to shift allocations between asset classes that is counter-intuitive to human decision making. It is unlikely that an asset class that has done well will continue to generate above-average returns for indefinite time periods. Nobel Laureate William Sharpe observed that many investors will make asset allocation decisions without looking at the relative market values of the asset classes and the future prospects of those asset classes. Investors will balance back to target allocations when in some cases investors should hold even less of an asset class. (William Sharpe, interview at Index Universe, May 2008). TAA involves having some skepticism when presented with a rosy scenario that the market accepts.

Many corporate finance professionals are finding that information is priced into asset class relationships quickly and are unable to keep up. Hedging and risk management have evolved rapidly in the last 20 years. So not only does TAA offer a risk and return benefit, institutional investors are finding it advantageous to have this asset allocation decision managed for them.

TAA is not “market timing”. Market timing takes a short term and reactive view of the market. TAA proactively invests in multiple asset classes over a longer time horizon and is used for risk reduction.

To illustrate the point, imagine a peak of a bull market with a future 50% drop in valuation over the next 12 months about to happen. At that point in time, if we allocate 100% into equities we will experience a 50% drop in valuation over the next 12 months; however if we had allocate 100% into Treasuries we will experience a positive return. The timing of when you make asset allocation decisions is critical to your long run returns. Obviously, your asset allocation rebalancing decisions can have a great influence on your overall returns over time.

The tactical asset allocation manager becomes a member of the plan sponsor team. The manager is permitted to use the asset allocation ranges previously set up by plan sponsors. As a result, you will see lower correlation between asset classes and increased transparency in the construction of the investment portfolio.

How is a tactical manager evaluated? It is the responsibility of a manager to clearly set forth a forecast and establish a rational decision making process. Since the manager now has the authority to make changes to the portfolio within the permitted asset allocation ranges, the understanding of how a manager makes changes needs to be clear.

Process

The approach for tactical asset allocation is a three set process: (1) a general framework for what the strategy is trying to accomplish, (2) factors which are important to the decision process, and (3) a method of making the asset allocation decision.

General Framework – The framework for a tactical asset allocation process addresses the specific objectives and focus of the strategy, including the philosophy toward returns and risk. The general framework may be flexible to meet individual client needs.

Return – The general goal of tactical asset allocation strategies is to increase either absolute or relative returns.

Risk – Risk may be viewed in many ways, such as failing to meet the return objective over the time horizon, volatility of returns, or probability of losses.

Decision Factors – Tactical asset allocation approaches vary according to the factors which are used in the investment decision process. Decision factors include valuation, business cycle, technical, and other, although approaches may use any combination of these.

Valuation – These methods are based on the belief that expected asset class returns are related to fundamental factors which can be directly observed or reliably forecasted.

Cyclical/Economic – These methods are based on the belief that the fundamentals driving the markets are related to the business or economic cycle.

Technical – these methods are based on the belief that certain technical factors contain information about future asset class returns.

Decision Rules – The tactical asset allocation process combines and weighs the decision factors to determine the asset allocation. The decision rules are usually systematic and disciplined, although there may be varying degrees of subjective judgment.

Historic Norms & Heuristics – These approaches compare the current values of the decision factors with their historic norms and apply a decision rule related to the difference. For example, a price-to-earnings ratio less than the historic average might increase the asset allocation to stocks.

Optimization – These approaches are quantitative decision rules which make an optimal trade-off between return and risk.

Implementation

The implementation of the process has the potential to either enhance or hinder the returns from the asset allocation process. The stocks and bonds in the portfolios may be indexed or actively managed, and futures or options may be substituted.

References

Davis, Joseph H., Francis M. Kinniry, Glenn Sheacy, 2007. The Asset Allocation Debate: Provocative Questions, Enduring Realities, Vanguard Investment Counseling and Research.

Tokat, Yesim, Kimberly A. Stockton, 2006. A Primer on Tactical Asset Allocation Strategy Evaluation, Vanguard Investment Counseling and Research.

De Silva, Harindra, 2006. Modern Tactical Asset Allocation, CFA Institute.

Goodsall, William, Tactical Asset Allocation, Association for Investment Management and Research.

Mortorana, Robert, 2009. How Tactical Asset Allocation Will Transform Wealth Management, Seeking Alpha.

Considine, Geoff, 2008. Tactical Asset Allocation, Part 1, Seeking Alpha.

Theodore, Theodore M., 1996. Trading Patterns of World Markets, Avatar Associates.

Arnott, Robert D., 2004. The Policy Portfolio Problem, CFA Institute.

Arnott, Robert, D., 2008. Patience Helps in Low-Return World. RAFI Fundamentals.