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NEW AGE FOR TACTICAL ASSET ALLOCATION

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There have been many changes across the institutional investment landscape post-financial crisis, with one of the more intriguing being the willingness of institutional investors to consider and implement tactical asset allocation strategies. Since the development of current institutional investment governance practices, which started evolving in the mid-1970s, allocating assets tactically has been anathema to investors. However, since 2008 we have seen a subtle, but noticeable, shift in the attitudes of investors towards tactical approaches.

This paper will (1) define tactical asset allocation strategies, (2) examine asset allocation practices pre-2008, (3) discuss the factors that are leading investors to consider a change and (4) show how to implement tactical strategies.

What is tactical asset allocation?

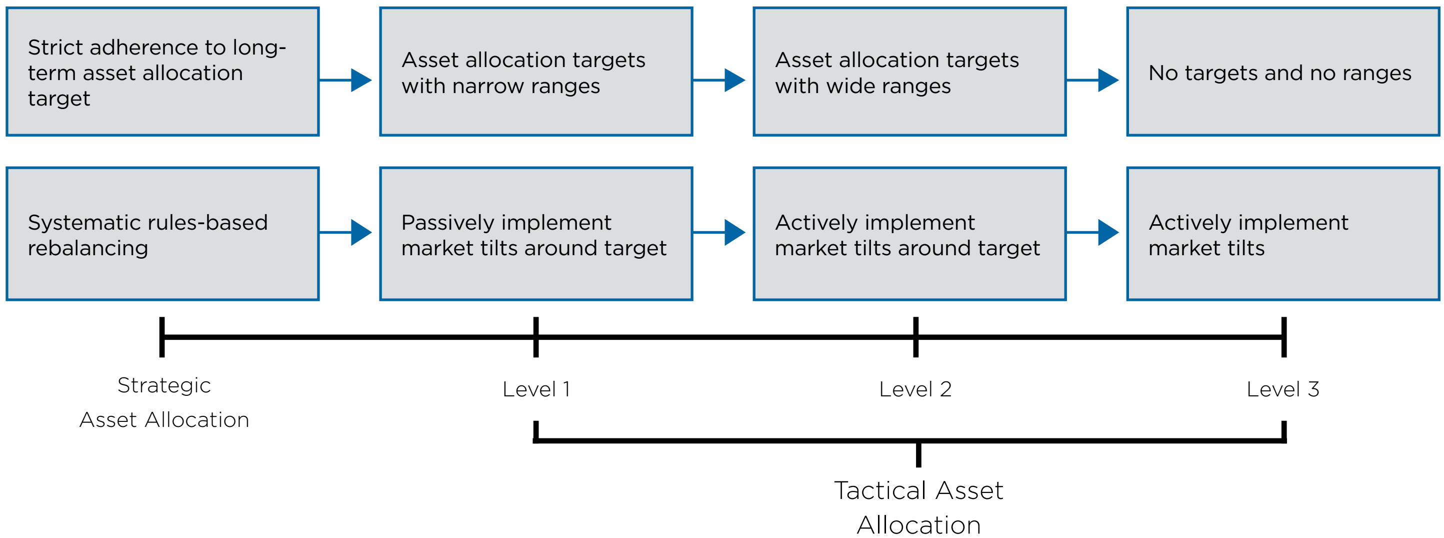
No one investor has the same definition of tactical asset allocation. In order to provide clarity, perhaps we can juxtapose tactical asset allocation against what it is not, a method called strategic asset allocation. Strategic asset allocation develops a long-term asset allocation target (how these targets are developed is beyond the scope of this paper) and assets are rebalanced systematically to the target over time. Two words in that definition are critical and differentiate strategic from tactical asset allocation: long-term and systematically. By long-term we mean that the targets are intended to be effective for at least three- to five years. By systematic, we mean a rebalancing technique that is rules-based and implemented consistently regardless of market conditions.

There are many gradations of tactical asset allocation, starting with an approach that is only slightly different from strategic asset allocation and moving along a continuum that ends with an approach most investors would associate with market timing.

Level 1

With Level 1 tactical asset allocation, the investor develops a long-term asset allocation target, similar to strategic asset allocation. The differentiation between Level 1 and strategic asset allocation is that there is no systematic rebalancing. In most cases, each asset class within the portfolio has an asset allocation range with an associated target. These ranges may be narrow, for example plus or minus five percentage points from the target. The investor usually develops an opinion about which asset classes are over or undervalued. Asset class over or underweights, however, mainly occur as a result of asset appreciation or depreciation relative to other asset classes. These asset class over or underweights may be enhanced as a result of cash flow decisions on the part of the investor. For example, if the investor believes that large-cap equities are undervalued, contributions to the portfolio may to directed to large-cap equities. A distinguishing characteristic of Level 1 is that the tactical bets are implemented more passively than Levels 2 and 3. Rebalancing occurs when the investor has a change of opinion about asset class valuation or when an asset class allocation is close to its

Asset Allocation: Strategic or tactical?



corresponding range boundaries. The critical distinction between Level 1 tactical and strategic asset allocation is that the investor has an opinion about the market and that opinion influences the asset class weights in the portfolio. However, in a Level 1 situation, the asset class over or underweights are never substantial and are constrained by narrow asset class allocation ranges.

Level 2

Level 2 tactical asset allocation is similar to Level 1 with two exceptions: the asset allocation ranges tend to be wider than Level 1, say plus or minus 10 percentage points or greater, and asset class over or underweights are enhanced by active rebalancing decisions made by the investor. For example, if the investor believes that large cap equity is undervalued and small-cap equity is overvalued, the investor will move assets from small-cap to large-cap. In Level 1, the over or underweights were attained in a more passive approach. As with Level 1, rebalancing occurs when the investor has a change of opinion about the market or when the asset class allocations are close to their corresponding range boundaries.

Level 3

Level 3 tactical asset allocation is the most unconstrained of the three levels. Asset class targets may not exist and asset class ranges may be very broad. The investor has a strong opinion regarding relative asset class valuations, and asset class weights are changed only when the investor has a change of opinion regarding the market. Since there are no long-term asset allocation targets, rebalancing does not occur. Level 3 tactical asset allocation is closely associated with the much maligned phrase: market timing.

In an attempt to provide a definition, I have conveniently created these three tactical asset allocation levels. In practice, investors implement various forms of tactical asset allocation that fall along a continuum highlighted by increasing investor activism and less willingness to be constrained by asset allocation targets.

Asset Allocation Practices Pre-2008

Since the mid-1970s, when current institutional governance practices started evolving, most institutional investors have used the strategic asset allocation approach or its close relative, the Level 1 tactical asset allocation approach. There are several reasons why investors migrated in this direction.

Firstly, there was the belief that tactical asset allocation techniques didn't work. Quite simply, investors did not believe it was possible to successfully and consistently implement market timing calls. Investors didn't distinguish between the various levels of tactical asset allocation...all levels were associated with market timing.

Secondly, tactical asset allocation required somebody to have an opinion on the market. Investors were uncertain of who to rely on for that opinion and how to implement that opinion.

Faced with these roadblocks, investors found it easier to use a strategic asset allocation approach or the Level 1 tactical approach. Many investors adopted the Level 1 approach because they had an opinion on the market and Level 1 allowed them to express that opinion in a stealth fashion as there were no active asset allocation bets.

Why Investors are Reconsidering Tactical Approaches?

Coming out of the 2008 financial crisis, many investors started to reconsider their long-held opposition to tactical asset allocation. This shift in opinion came about as investors observed the futility of rebalancing into a rapidly declining market. The strategic asset allocation approach did exactly that. As equities declined in value, the strategic approach required investors to increase the equity allocation back to target, only to see this new allocation disappear as markets continued to decline.

Investors realized that a rules-based rebalancing technique was inappropriate in both rapidly declining markets and volatile markets. Perhaps it was possible to take an opinion on the market and effectively incorporate that opinion into an asset allocation strategy.

One manifestation of this shift in thinking has been the growing popularity of tactical asset allocation funds post-2008. Although few investors retain a TAA manager for their entire portfolio, there is a growing cohort that retain a TAA manager for a "sleeve" of their portfolio.

In addition, investors have come to distinguish between market timing and less extreme forms of tactical asset allocation, such as Level 2.

However, now that more investors have come to accept the efficacy of tactical approaches, there still remains the significant governance hurdle of who develops an opinion on the market and how to implement that opinion.

How to Implement a Tactical Strategy

In an institutional asset management environment, there are four groups that are positioned to develop and implement a tactical allocation strategy: investment committee, management (usually the CFO, CIO or Treasurer), investment consultant or investment manager.

In deciding which group is best positioned to develop and implement a tactical strategy, three factors should be considered:

- **Resources:** the group has the resources to develop a broad view on the market encompassing all markets including traditional equities, traditional fixed income, and alternatives.
- **Experience:** the group has been developing this market view for an extended period of time.
- **Performance:** the group has a track record of successfully implementing this view in a tactical framework.

Based on these three factors, it would seem that investment consultants or some investment managers, those that have tactical asset allocation experience, would be best suited to develop and implement a tactical strategy. Most investors, and by extension I mean investment committees or management, do not have the dedicated resources to consistently develop this broad market view.

Once the group has been selected, the investor needs to make one final decision. Prior to implementation, does the tactical strategy need to be reviewed or authorized by the investor? Another way to state this, does the group that develops and implements the tactical strategy have investment discretion? If the tactical strategy does need review or authorization, who performs the review or grants authorization on behalf of the investor?

Success of tactical strategies depends to some degree on timing. The more unconstrained the strategy, moving along that tactical continuum that we discussed previously, the more important becomes timing. A review or authorization process would potentially slow down the implementation of the tactical strategy. Review or authorization by the investment committee presents some challenges. Committees don't meet frequently enough and would not feel they had enough knowledge to perform an adequate review. If a review or authorization was built into the process, it may make sense to have one person with that authority. The person best positioned for that would be the CIO or the equivalent. However, as long as the tactical strategy and the corresponding written guidelines were clearly stated at the onset of the strategy, the discretionary approach may be the most effective. What is critical in the discretionary mode is effective communication between the consultant or investment manager and the investor. The consultant or manager would state their view on the market and coincident with all decisions, communicate those decisions to the investor.

Conclusion

More investors are considering and implementing tactical asset allocation strategies since the financial crisis. Investment consultants and some investment managers may be best positioned to implement those strategies. Since nimbleness and timing can be critical components to the success of a tactical strategy, reviewing governance practices to assure an efficient committee decision-making process, or granting the consultant or manager investment discretion may improve effectiveness.

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