Using Tactical Investment Strategies in a Passive Investing Environment

By Ricardo L. Cortez, CIMA®

The rush to passive investing has accelerated in recent years. In 2016, there was a record net new cash inflow in domestic equity index funds (including exchange-traded funds) of more than $250 billion. At the same time, there was a record net outflow in domestic equity active funds of more than $300 billion. Many market participants have asked if this is the new model for investment management. Figure 1 appears to suggest that this trend is a persistent rather than cyclical phenomenon. It leaves many wondering: Why should an investor hire an active manager if active management returns have not exceeded that of unmanaged market indexes? Is active management dead?

At this time in the economic and stock market cycle, the U.S. stock market has shown continuous positive returns for every year since 2009. So it is prudent to ask: At what point will the market undergo the type of correction to the uptrend that typically occurs after economic expansions? This question is particularly important for those investors whose time horizon is less than 10 years. Remember that if your investment portfolio declines 50 percent, as it did during the last recession, you must double your money just to get even. Does the investor’s portfolio have sufficient time to recover? Consider also that the stock market advance since 2009 has lifted all boats. High-quality and low-quality securities alike have been buoyed by the rising market tide. Active investment managers that discern quality from lesser-quality securities have been at a disadvantage because the stock market has not rewarded this distinction.

Further, the U.S. Federal Reserve (the Fed) monetary policy over the past eight years has kept interest rates low and created an environment where stocks are far more attractive than bonds. In 2016, more than 60 percent of the stocks in the S&P 500 Index had a higher yield than the 10-year U.S. Treasury note (see figure 2), providing a decided advantage for stocks over the fixed-income sector.

Figure 1

Figure 2
THE INVESTMENT CLIMATE HAS CHANGED

In the past two years, the Fed reversed course and has begun to tighten monetary policy. The Fed likely will continue to be less accommodative over the next few years by gradually raising interest rates, reducing its balance sheet, or a combination of both. This tightening process already has cut in half the percentage of S&P 500 stocks with yields above the 10-year Treasury note (see figure 2). We expect this trend to continue, reducing the advantage that stocks have had over bonds. This shift will have major implications for the capital markets as the largest financial institutions reallocate among stocks, bonds, and cash. In addition, stock market valuations are elevated by any measure. The median price–earnings ratio (P/E) on the S&P 500 is at its highest level in more than a decade, even higher now than it was before the 2008–2009 financial crisis.

Compared with historical stock performance based on P/E levels, the current outlook is not promising. Figure 3 shows S&P 500 Index levels of P/E broken down into three categories and the subsequent annual returns, with the more expensive the P/E, the worse the return. The S&P 500’s current P/E is 23.8, placing it in the most expensive historical category, with an annual return of only 2.51 percent. This environment is decidedly unfavorable for passive investing.

During 2004–2007, no one thought real estate prices could fall. In the late 1990s, the financial press spoke of a “new paradigm”—the dot-com era. In 1987, the buzzwords were “program trading and portfolio insurance.” In the early 1970s, the accepted investment wisdom was to buy the highest-quality growth stocks (“The Nifty Fifty”) and hold them forever. And in 1929, Yale economist Irving Fisher proclaimed in the New York Times that “stock prices have reached what looks like a permanently high plateau” days before the crash.

In each of these instances, stock prices subsequently dropped significantly—in some cases, by 50 percent or more.

After the 2008–2009 financial crisis, investors lived in the “Golden Age of the Central Banker,” as Ben Hunt, PhD, chief investment strategist at Salient, has termed it. Investors were not worried because the U.S. Federal Reserve and global central bankers always provided enough liquidity to keep the markets from significant declines. As Mario Draghi, president of the European Central Bank, famously said, they were committed to do “whatever it takes.” Though some may still believe we are living in the Golden Age, the world has devolved now that investors no longer necessarily can rely on central bank policy.

Figure 4 shows the current situation with respect to asset prices versus gross domestic product (GDP) in the United States. Asset prices are as stretched as they have ever been compared with the rate of growth of GDP.

On behalf of our clients, we investment advisors support lower fees in order to gain exposure to asset classes and market segments for the purpose of diversification, particularly in a low interest–rate environment. We believe that tilting portfolios toward various fundamental metrics can add significant value. We further believe that this move toward lower fees and a greater use of market index securities is a secular trend that is likely to continue. Indeed, our team’s securities investments concentrate largely in only the most–liquid equity market indexes.
The central problem with passive investing is that it does not offer a method of managing systemic risk. Passive investing provides a method of diversifying portfolios among various asset classes, which can be effective in reducing nonsystemic risk, but it offers no way of addressing the risk of a more general stock market decline or global financial crisis.

During major stock market declines, all correlations go to 1.00; everything declines. Some well-diversified passive portfolios may decline less, but not in any significant way. In 2008–2009, telling clients that their portfolios were down only 40 percent versus the 50-percent decline in the general market was little comfort. Yet a significant drop right along with the market will occur if investments are limited to passive market indexes only. Remember that many passive investments have a higher beta than the general market, so an investor could lose significantly more than the general market depending upon the particular choice of passive index.

Investors who experienced the last financial crisis do not want to be subject to those types of risks again. They want to make sure that their financial advisor has a plan for dealing with the next crisis. What is the 65-year-old anticipating retirement to do if the market declines 50 percent, as it did in 2008–2009? What is the pension fund, foundation, or endowment to do if returns in the next decade average only 2.5 percent and there is a major decline in portfolio value?

That is a perfect storm, and a fully invested passive portfolio has no safe harbor.

**IMPLEMENTING A TACTICAL APPROACH INTO A PASSIVE ASSET ALLOCATION**

Consider a hypothetical traditional portfolio allocation that is 70-percent equities and 30-percent fixed income established through the use of exchange-traded funds.

Investors use the following two strategic approaches to optimize asset allocation to the individual sectors:

- Long-term historical returns and standard deviations for each sector
- Forward-looking performance estimates and estimated future standard deviations for each sector

If we believe that (1) future returns of stocks or bonds may be below their historical averages and (2) the market may be subject to a normal correction of 20 percent or more within the next year or two, we would argue that using either of the two strategic approaches would be insufficient to protect a portfolio in any significant way. Strategic reallocation through optimization would mean that you would simply lose less.

The approach we favor reduces the 70–percent equity allocation to 40 percent and reallocates the remaining 30 percent to a tactical manager with a history of capturing a portion of the upside equity returns—and, most importantly, who was either flat or up in the bear markets of 2002 and 2008. If interest rates were to increase and there was fear of higher short- and long-term rates, we would take the additional step of reducing the 30–percent fixed-income allocation to 20 percent, reallocating the remaining 10 percent to a tactical manager with a proven track record during periods of rising interest rates.

We therefore believe that a 30–40–percent allocation to tactical strategies is appropriate in view of high equity valuations accompanied by a tightening of monetary and credit conditions.

**EVALUATING POTENTIAL TACTICAL STRATEGIES**

No one has a crystal ball to look into the future, but we believe the following questions should be addressed by investors who cannot sustain a large loss, however temporary, in their portfolios. In our opinion, these concerns cannot be resolved by passive investing and lower fees. A lower investment fee will pale in comparison with the potential loss that could occur in market value during the next recession and stock market decline, to say nothing of the geopolitical risks or black swan events that could occur.

Continued on page 60 →
TACTICAL INVESTMENT STRATEGIES
Continued from page 57

Tactical strategies, on the other hand, can offer the investor a method of risk control that may (1) cushion the impact of severe stock market declines and (2) offer the potential for true non-correlation by providing potential positive returns during these periods. These strategies can offer financial advisors a plan for their clients with a manager with a time-tested discipline that can help preserve capital in case of a severe stock market decline. Perhaps most importantly, tactical strategies help provide clients with the confidence and comfort that the manager can and will act immediately to move to help protect the portfolio during turbulent times.

Evaluating tactical strategies is not easy. Financial advisors and their clients should conduct a thorough analysis before investing that should include the following:

- How did the manager perform during the bear market periods of 2008–2009 and, if available, 2001–2003? (Any back-tested performance returns must be discounted in this analysis.)
- Did the manager exceed its own stated goals and benchmarks during this time?
- How did the manager perform compared to other managers in the tactical or appropriate alternative investment category?
- Is the same investment team in place that provided the past history of performance?
- How liquid is the portfolio in case of internal or external shocks to the capital markets?
- How scalable is the strategy in cases of significant changes in assets? How would a large increase or decrease in assets affect the ability of the manager to execute its strategy?
- How often are the manager’s models updated? Would the mandate prevent the manager from taking immediate action if the models are updated infrequently?
- What is the manager’s risk management discipline and how repeatable is this process? What is the manager’s worst month and worst drawdown?

If well-selected with the proper care and due diligence, tactical investment strategies may offer a powerful way to insulate portfolio losses and provide noncorrelated investment returns.

CONCLUSION
It is true that tactical strategies, and many alternative and hedge fund strategies, have been out of favor for the past five years. Most of these strategies have not kept pace with the S&P 500. However, Warren Buffet said it best: “I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful.”

Significant stock market declines do happen. The time to invest in these strategies is exactly when you don’t think you need them and when no one wants them.

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