Tactical Investment Management

By Roman Chuyan, CFA®

Research dating back to 1986 has shown that about 90 percent of risk-return for a diversified balanced portfolio comes from asset allocation (Brinson et al. 1986, 1991). This was blatantly confirmed by the severe equity bear market of 2007–2009: Most U.S. equity portfolios, regardless of style, lost about 50 percent from peak to trough. Since then, investment advisors have been searching for effective ways to help clients avoid repeating that experience. Many have turned to tactical investment strategies to deliver above-index return, especially on the downside. Tactical management, however, is a broad and ambiguous term that includes a variety of active investment strategies often unrelated to asset allocation. Further, some of the most popular strategies have underperformed the broad market in recent years.

So, how does tactical management relate to asset allocation and more generally to modern portfolio theory (MPT)? And, how can an advisor implement a tactical strategy that has a good chance of success? In this article I hope to add some clarity to the subject and provide an example of how advisors can implement a tactical strategy for clients.

Definition

Tactical management or tactical asset allocation (TAA) can be described as focusing portfolios on asset classes with the best near-term expected returns and risks. The key word is “expected”; tactical management is forward-looking (and so is all active investing, for that matter).

Tactical investment management therefore involves estimating future asset class returns and is a form of active management. Tactical management focuses on evaluating expected returns of entire asset classes, such as U.S. equities, fixed income, countries, or styles. For comparison pur-
poses, tactical management can be contrasted with security selection (another form of active management), which focuses on analyzing and assessing the prospects of individual companies.

Tactical Management and MPT

Where does tactical management fit within MPT, and within its cornerstone, the capital asset pricing model (CAPM)? CAPM states that every asset’s expected return is proportional to its beta, with zero expected alpha. Only market risk is rewarded. A portfolio different from the market portfolio involves additional risk but no additional expected return. Therefore, CAPM leads to passive strategic asset allocation (SAA)—buying and holding an index portfolio. CAPM itself is a social theory based on a number of assumptions that might not apply in practice, but SAA is a robust investment approach practiced by many institutional, high-net-worth, and retail advisors, and for good reasons. This low-cost strategy is objective and avoids emotional decision making, which is investors’ worst enemy. It is suitable for most investors who are comfortable with achieving index returns. Of course, it achieves index returns on the upside as well as the downside; it doesn’t include anything to help investors mitigate another 2008 experience.

Active investment management should build upon MPT rather than argue against it. Players in this somewhat-efficient market have different information. Better, more thorough forward-looking analysis leads to better opportunities to earn above-index returns. However, MPT’s message is consistent with practical evidence: Few managers actually achieve consistent above-index returns. For example, only 14.1 percent of U.S. equity fund managers outperformed an index over three years after fees, according to the mid-year 2014 Standard & Poor’s SPIVA study. This puts the burden of proof on the active manager. Managers must do their homework and work hard to develop investment strategies that increase the chance of beating a passive benchmark.

Simplistic strategies can hardly work well over time. Many popular tactical strategies are based on only technical indicators—various compilations of past price information and sometimes volume. This is why some tactical strategies that gained popularity after 2008 have been underperforming in recent years. For example,
Trend-following underperformed significantly in 2011, and 2014 turned out to be an especially challenging year for several popular trend-following and sector-rotation strategies. Active strategies must contain an edge to achieve a significant positive performance versus a passive benchmark. To continue to work over time, they also must be resistant to crowding, i.e., being replicated by multiple managers.

A Sound Approach to Tactical Management

MPT, confirmed by practical evidence, tells us that tactical management is as challenging as any active management in this somewhat-inefficient market. I would recommend that to have a shot at success, a tactical strategy must stick to the following principles:

Tactical management must be forward-looking. Technical indicators, which lag by definition, cannot work well. Numerous studies have demonstrated that markets are somewhat efficient, at least at the weak level of the efficient market hypothesis, i.e., past price and volume data are priced-in instantly by the market.²

Tactical management must be systematic. A method or strategy must be applied systematically and consistently over time to avoid the worst pitfall of active management, which is making subjective emotional decisions. This is what a global tactical asset allocation (GTAA) style approach based on global-macro views often is lacking; it's typically based on forward-looking analysis, but it also can be subjective.

Tactical management must be tested. A strategy or method should be tested for skill, not just for historical performance.

The Next Step

I described above how CAPM/MPT—the de facto standard of investing—leads to passive investing. Active investment management benefits from such insights, but it doesn't fit into this framework, which originated in the 1960s. Let us now take it a step further to see how tactical management works within an active management framework. Though not as ubiquitous as MPT, such a framework does exist. It was pioneered by Richard Grinold and Ronald Kahn in the 1990s and summarized in their exceptional book, *Active Portfolio Management* (1999).

CAPM is based on the consensus-expectation assumption: Everyone agrees on expected asset returns. This leads to the conclusion that the optimal strategy is buying and holding the market portfolio, which is a mix of public indexes. Active managers, on the other hand, invest in portfolios that are different from the public index benchmark. These managers are, at least implicitly, forecasting future asset returns that are different from the consensus.

According to Grinold and Kahn (1999), explicit (rather than implicit) forecasting of asset returns is optimal. Forecasting for individual securities leads to security selection; forecasting for asset classes leads to market-timing, or TAA. Return forecasting does appear to have very important benefits. First, explicit forecasting lends itself to a systematic management process. The process can then maximize expected risk-return opportunities, unimpeded by subjectivity. Second, a set of historical forecasts (real-time or back-tested) enables measurement of skill.

How can we measure the skill of a strategy, manager, or method? It turns out that past performance is a weak measure of skill, because it's based on a single market scenario—what actually happened in the market. This is why performance doesn't persist; most managers underperform over time (remember the SPIVA study). The correlation between forecasts and actual returns (termed the “information coefficient” by Grinold and Kahn) is a better measure of skill. According to Grinold and Kahn (1999), active performance over benchmark (alpha) is proportional to the information coefficient (IC) and to market volatility (Vol), where Score defines how frequently or actively the given method is applied.

\[ \alpha = \text{Vol} \times \text{IC} \times \text{Score} \]

So, IC is a critical ex-ante determinant of active performance.

Tactical Asset Allocation

Research has shown that about 90 percent of risk and return for a diversified, balanced stock-and-bond portfolio comes from asset allocation (Brinson et al. 1986, 1991; Ibbotson and Kaplan 2001). So, it makes sense to focus active management efforts on asset allocation, because active (tactical) asset allocation has great potential to add alpha.

Tactical management had been largely overlooked by the investment industry until around 2009, I think for two reasons. The first is that there was almost no practical need for it during the bull market of the 1980s and 1990s, because buying during the dips was all an asset allocator needed to outperform. The severe equity market downturn of 2007–2009, however, reinforced the need for tactical management, and it has been increasing in popularity since. The second reason was the concept that “one can't time the market because the market is efficient.” In my view, this resulted partly from conceptual confusion and partly from unfamiliarity with the active management framework, which, after all, is fairly recent, dating from the 1990s. Tactical management is as challenging as all of active management, and simplistic strategies can hardly work for any active management (whether tactical or security selection).

TAA strategies vary in asset-class exposure and complexity. They can be fairly simple, focusing on only major U.S. asset classes (equities, fixed income, and cash), which well-suits a U.S. investor base. Sophisticated institutional managers develop strategies that allocate to a broad set of global markets. As long as they adhere to the three principles listed above, both U.S.-only and global strategies have a good chance of success. Breadth helps, but only as long as forecasting accuracy (IC) stays reasonably high, and it's challenging to accurately forecast a large number of markets. An example of how TAA was implemented successfully at a pension and endowment management organization is described by de Bever et al. (2013).

Most of the alpha in TAA strategies results from the decision to allocate to risky equities
(a “risk-on” decision) versus less-risky fixed income or cash (“risk-off”). Typically, more than 85 percent of risk in a balanced 50/50 or 60/40 portfolio comes from equities. Getting out of the way of a significant equity market downturn based on a forward-looking model commonly accounts for most of alpha in TAA strategies. Although certainly riskier, equity is nonetheless the asset class with the best long-term expected return. Therefore, the goal is to reduce the equity market downside (i.e., to be conservative) and to participate in the upside. As such, it makes practical sense to focus on forecasting a broad equity market such as the S&P 500 Index.

Figure 1 is an example of forecast-model results for the S&P 500 that shows the resulting buy (risk-on) signals and sell (risk-off) signals since 2008. This is an empirical model, implemented using multi-factor regression. In developing this model, the manager found that only fundamental-type factors (including U.S. economic indicators and index valuation) were statistically significant in influencing S&P 500 returns over time. Technical indicators were tested extensively but did not prove to be significant. This statistical exercise confirms the concepts discussed above and matches the intuition of most managers that fundamentals drive markets.

A Practical TAA Implementation

Effective TAA strategy once was an option available only for sophisticated institutional managers. Now advisors can efficiently implement it for high-net-worth or retail clients thanks to advances in separately managed account (SMA) and unified managed account (UMA) platforms and to growth in the exchange-traded fund (ETF) market.1 This section illustrates how an advisor might approach this implementation.

An advisor would start with the client’s SAA target asset mix—for example, a typical 60-percent equity, 40-percent bond allocation. The advisor, in consultation with the client, must determine the advisor’s management discretion around the target, if it doesn’t already exist, commonly a +/- 10-percent range.2 In this case, equity allocation would vary from 50 percent to the maximum of 70 percent. Figure 2 shows an example of how a portfolio’s equity allocation might look over time. A model portfolio then should be created for each group of clients with similar SAA allocations and ranges, which would allow the advisor to manage efficiently a large number of individual client accounts on an SMA/UMA platform, or to authorize a third-party investment manager who specializes in tactical management.

To introduce a tactical strategy into client portfolios, the advisor would designate to the strategy a portion of the portfolio equal to the discretionary range, which is 20 percent in our example. The rest of the portfolio would remain allocated to its core/SAA asset classes—U.S. and global equities, fixed income, etc. These core/SAA allocations may continue to be invested in individual securities, funds, or exchange-traded funds (ETFs), and introducing a new tactical sleeve would not disrupt the core allocations in any way. In this example, the tactical strategy varies its equity allocation from 0 percent to 100 percent, with no short-selling or leverage. The resulting client portfolio allocation would then vary from 50 percent (when the tactical strategy is in risk-off mode, with 0-percent equity allocation) to 70 percent (when the tactical strategy is in risk-on mode), as shown in figure 3.

Finally, the tactical strategy might be effectively implemented by utilizing ETFs. Most
broad index-based ETFs are very liquid, track their respective indexes closely, and have low management fees. For example, to obtain exposure to the S&P 500 Index, the advisor can buy the iShares Core S&P 500 ETF (IVV) at a 0.07-percent annual management fee, or the SPDR S&P 500 Index ETF (SPY) at a 0.09-percent fee. To implement long-term fixed-income exposures, one could use the iShares iBoxx $ Investment-Grade Corp Bond ETF (LQD) or the iShares 7–10 Year Treasury Bond ETF (IEF), both at a 0.15-percent fee.

Once this infrastructure is in place, the advisor or designated outside manager makes risk-on/risk-off decisions based on forecasts of near-term asset class returns, focusing on the equity market as the primary source of risk. I’d like to stress that choosing or developing a sound method for making tactical investment decisions is a critical part of a TAA implementation, which may take significantly more resources and time than the operational mechanics required to implement it into client portfolios. To have a good chance of success, tactical management ought to adhere to the principles described above: be forward-looking, systematic, and tested. Ideally, it should be based on a statistical model that is continuously tested for accuracy, robustness, and structural shifts. Larger investment managers might develop these capabilities internally and smaller registered investment advisors, family offices, and managers likely will find it more efficient to outsource this process.

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Endnotes
2. An excellent overview of EMH research is provided by Sewell (2011). Researchers started to notice random behavior of markets as early as the 1920s. Fama (1965) defined an “efficient” market for the first time, in his landmark empirical analysis of stock market prices that concluded that they follow a random walk.
3. Most separately managed account (SMA) and unified managed account (UMA) trading platforms include functionality of assigning groups of clients to portfolio models, with an option to authorize a third-party investment manager to manage the portfolio models.
4. Institutional managers often use active risk limits instead of ranges; either one works, and one can be translated to the other.

References

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