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Active Tactical Asset Allocation Investors Need Diversification of Strategies

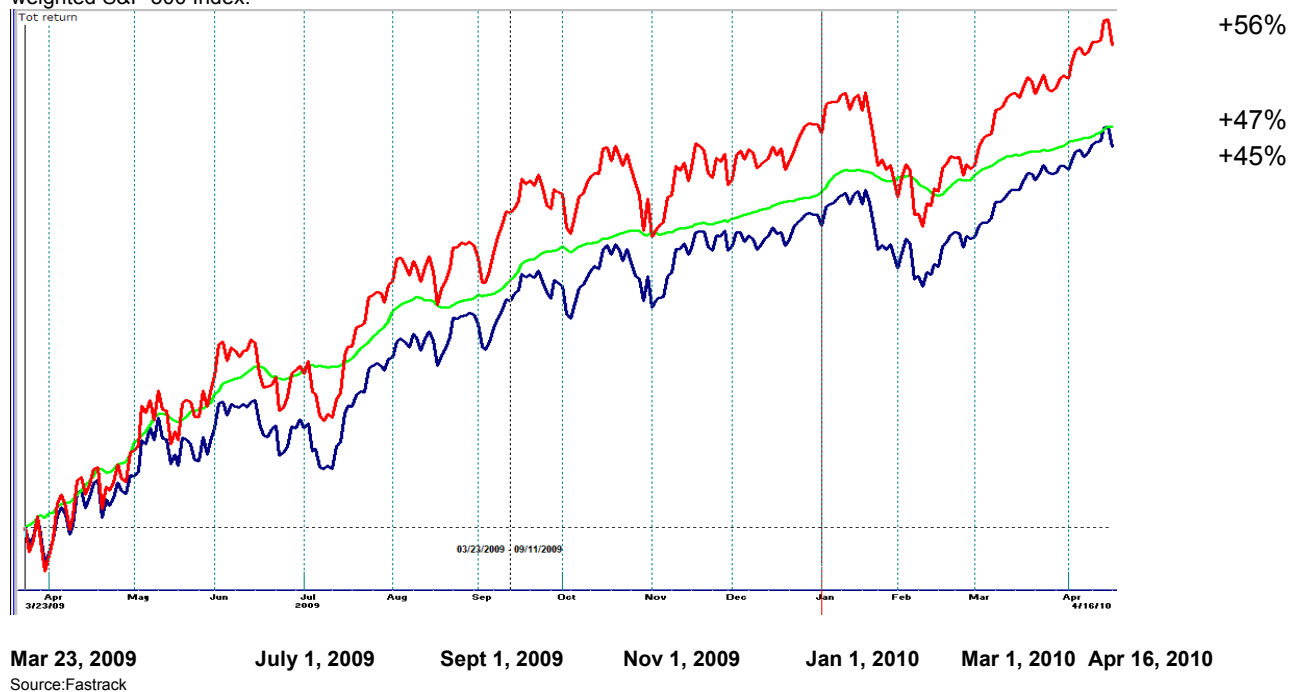
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I am going to alter our Monthly Market Commentary a little this month. First, I will provide a quick update on domestic high yield corporate bond funds versus equities. Then I want to provide you with some thoughts about why Active Tactical Asset Allocation is a good idea for client portfolios and why professional advisors and clients still may not be using this proven investment management strategy.

Below is a comparison chart of HY versus an average of some widely followed major equity indices and the S&P 500 Index. Clearly one can see that HY have not only performed nearly as well as the simple equal weighted average of these equity indices, but more importantly have done so with less volatility – the green line below is the smoothest; that is the high yield corporate bond average index!

March 23, 2009 to April 16, 2010 – Equities versus High Yield Corporate Bonds

The Red Line is a global equally weighted index composed of five major global equity indices (20% S&P 500 Index, 20% Russell 2000 Index, 20% Nasdaq OTC Composite, 20% iShares MSCI EAFE Index, 20% iShares MSCI Emerging Markets Index). **The Green Line** is a high yield equally weighted index composed of two hundred twenty domestic high yield corporate bond funds. **The Blue Line** is 100% weighted S&P 500 Index.



The high yield bond fund (HY) index we compose, as displayed as the green line above, continues to display one of the most stable charts in the investment universe, and of course HY continue to provide a very attractive current interest rate – they still yield in excess of 7.0% on most high yield corporate bond funds.

Active Tactical Asset Allocation, some call it “Market Timing”, should be a part of every well diversified client portfolio. Why is it not used more often in retail client portfolio management today?

Here we are, 10 years into one of the worst equity markets in history, and still the investment advice and distribution industry does not hold “active tactical asset allocation” in very high esteem as a portfolio management solution. The kind of tactical asset allocation movements that I write of are the extreme ones, where at times the portfolio manager exits an asset class altogether. Some refer to this as market timing. In this article I will review some of the reasons that active tactical asset allocation is not used more often in retail client portfolio management. Had active tactical asset allocation been implemented in your clients portfolios during the past decade they would most likely be in better shape today than perhaps they are. It is never too late to diversify the solutions you offer to your clients, but first let’s address some of the hurdles or common notions to help you and your clients get past them.

Below are seven hurdles that I think our industry professionals need to overcome in order to be more comfortable recommending successful active tactical asset allocation strategies to their clients today.

Hurdle #1: I have been in the business for years and in the past whenever I used tactical managers they did poorly.

A tough argument to counter, except to say that if you used only one tactical manager in the past and they delivered poor investment results and that made you quit on active tactical asset allocation, then that quitting may have been just as poor of a decision as the decisions that manager made that led to the poor performance. Certainly you would not exit the buy and hold strategy for good if one mutual fund manager disappointed, would you?

Hurdle #2: Academic studies show that you should not attempt to time the market; you may miss the good times if you do.

Ah, the buy and hold proponents favorite argument. Yet there is more to this study that offers another, very important point of view. An investment in the S&P 500 Index for the period 1990 to 2008 in a buy and hold mode returned 5.0% annualized, yet if you missed only the **40 best days** your returns would have been an annualized loss of -4.92%; case closed, timing does not work. Wait a minute! The engineer in me says let’s look a little further. If you had instead missed only the **40 worst days** during that same 1990 to 2008 period your investment returns would have skyrocketed to 16% annualized per year, more than triple the rate of return of the buy and hold strategy. But our research department would not stop the study even there. We furthered the study to review what would happen to investment returns if you missed both the **best and worst 40 days** during that time period. Interestingly, when missing both the **best and worst 40 days** in that 1990 to 2008 period the investment returns were still better than the buy and hold; only by a small amount, but better. We found this very intriguing and quickly realized the reason why. It was associated with what we learned in fifth grade math class, that percentage losses require larger percentage gains to recover the losses. To recover a 30% loss one must make 43% to get back to even. Eureka! Protect against large downside losses and perhaps over time I will have a better investment experience.

Hurdle #3: There was a Nobel Prize issued to notable academics that showed that asset allocation is responsible for 92% of the returns from portfolio A to portfolio B.

WRONG! What they won the prestigious Nobel Prize for was identifying that asset allocation is attributable for 92% of the **variability of returns** from Portfolio A to Portfolio B; it was not about the **returns** from Portfolio A to Portfolio B. And yes, that study makes an immense amount of sense and actually provides a 100%

endorsement of active tactical asset allocation. If you asset allocate properly, you should be able to regulate the variability – known as volatility – of the portfolio. And that is actually what clients hire you for, to address the risks of investing and help them see their way through the risky, volatile world of investing.

Hurdle #4: Elliott Spitzer prosecuted market timing, so all market timing, or active tactical asset allocation, must be illegal.

The mutual fund companies that permitted the after hours purchasing of their funds, and whatever else that was lumped into those charges, were indeed in violation of securities laws, and they were punished accordingly. Furthermore, rapid trading in and out of buy and hold, long-term mutual funds can lead to excess trading costs and lower the mutual funds returns, which is not good for mutual fund shareholders, agreed. But active asset allocation does not need to be “rapid trading”. Instead it can be more along the lines of Intermediate Term Trend Following. Fact is some active tactical asset allocation strategies may only make 2 or less major moves per year – that’s less than most quarterly re-balanced, buy and hold strategies! Still, there are plenty of investment choices available to implement active tactical asset allocation movements – there are mutual fund companies that welcome it and there are also exchange traded funds.

Hurdle #5: Many professional advisors and their clients have engaged in their own form of active tactical asset allocation already, with little success.

Unfortunately, they incorporated the strategy of “emotions”, not a rigorous systematic approach. Most professional advisors have engaged in tactical asset allocation themselves from time to time. But most likely the decisions that led to the allocation decisions were emotionally rooted by those two bastions of emotion extremes – fear and greed! News flash - fear and greed are not an active tactical asset allocation strategy! Furthermore, more often than not when the fear and greed show up, it was probably time to do the opposite!

Hurdle #6: Behavioral Finance keeps investors away from active tactical asset allocation.

This article has space limitations and therefore I cannot give justice to the body of work that exists on this topic. Know that this may be the biggest impediment to using an active tactical asset allocation approach, because once you get past all the hurdles listed in this article, then you have to pull the trigger and make the trades, no matter what your so called “better judgment” is telling you. Studies have shown that people are **risk-averse** to taking a loss and **risk-accepting** to letting losers stay invested, in hopes of a positive rebound in the near future. Meaning, most people will hesitate to take a small loss, instead preferring to hang in there and hope to get back to even. That may be the single worst investment strategy there is – hanging in there to get back to even. The market does not care, whatsoever, about you and your client’s investment basis. Not one iota!

Along the same lines, investor confidence in an active tactical asset allocation strategy can be undermined when “whipsaws” occur. These are instances where you made say two investments in a row and realized losses on both – you think “I cannot take this anymore; I am stopping this investment strategy”. Oddly enough, one of the best investments we ever made in our long history of active tactical asset allocation here at Hanlon Investment Management was taking a 2% loss after taking a larger loss in the tactical move just prior to that. That 2% loss we harvested to exit the markets and go to conservative, stable value money markets helped our client portfolios avoid losses of 30-50% from there.

Hurdle #7: You must have a process, rigorously researched, back-tested and successfully used in real-time for more than a short period of time, and stick with it through thick and thin.

As with all investment management solutions, there must be a stable foundation to the overall active tactical asset allocation approach. It must have good long-term results and it needs to deliver on the promises, whatever they may be.

OK, one of your thoughts may be “this article is against buy and hold asset allocation”. **Absolutely not!** There is very much a place for that investment style in client portfolios. But all of us have been taught that diversification, at a minimum, is a prudent form of portfolio management. We think that the industry has not arrived at the point where they understand what diversification really means. It means not only to diversify your investment holdings by style, asset class, sector, etc. in the buy and hold approach, but it also means to offer a diversified selection of investment management strategies, with active tactical asset allocation being a weighted member. This should lead to better risk-adjusted return results at the household level for your clients.

Thank you for the opportunity to be of service.

Thank you,



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