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Market Ethos

The latest market insights from the Richardson GMP team

Static vs. Tactical

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"It's not timing the market, it's time in the market that counts" – We don't know who originally said this, but it's now used by financial services marketing departments around the world. In this Market Ethos, we explore the age-old debate between using a buy-and-hold – i.e. static – asset allocation approach, and one that is more tactical. Given one of our largest investment mandates is a tactical asset allocation strategy, we will do our best to remain objective.

Static Asset Allocation vs. Tactical

Let's start by defining several terms. Static Asset Allocation (SAA) is a buy-and-hold approach where an investor's portfolio allocation is based on their long-term return objectives and risk aversion. This allocation is often based on long-term asset class historical returns and correlations. Once an allocation is set, it remains static; in other words, it doesn't change over time. It may vary if the investor's preferences or objectives change, but that is a whole different topic. For the purposes of this report, SAA means a fixed allocation over time.

Tactical Asset Allocation (TAA) also begins with a baseline allocation based on an investor's long-term return objectives and risk aversion. However, the portfolio can be tilted to take an overweight (OW) or underweight (UW) position in different asset classes at different points in time to take advantage of opportunities or reduce risks.

Static Asset Allocation: This is by far the easier path. You simply determine a suitable allocation that gives you the best probability of reaching your goals based on historical returns and allocate away. Then you can ignore what is happening in the markets day-by-day and stick to your long-term plan. From a behavioural perspective, this has the bonus of reducing the risk of an investor/advisor making an emotion-based mistake such as capitulating near a market bottom or adding to equities after the market has already enjoyed a strong run. These two investment behaviours are often the biggest detractors from long-term performance and investment success. Consequently, an asset-allocation approach that helps mitigate these types of risk, is a positive.

One of the strengths of the SAA approach is also a significant weakness; namely, that it ignores the market.

Chart 1: Valuations do matter for subsequent returns

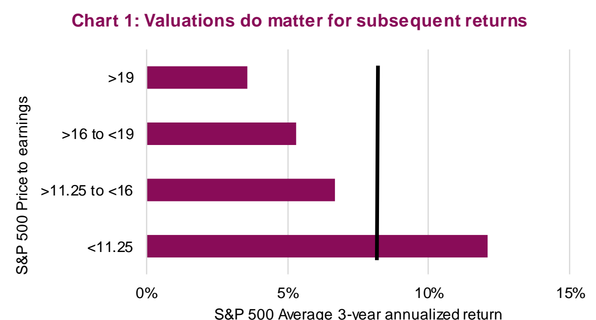

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Chart 1 is based on 85 years of S&P 500 price and valuation data. We broke the valuation ranges into quartiles and measured the average subsequent performance of the index. The black line represents the average of about 8%. As you can see, when valuations are high – in the top quartile of over 19x – return expectations are lowest. When valuations are lowest – below 11.25x – return expectations are highest. A SAA approach ignores this. In case you're wondering where we are today, it is near the expensive boundary of the second quartile. In other words, the market is expensive, which should mute return expectations.

Then there is the allocation to bonds. Equity returns tend to be rather volatile, which makes return expectations more challenging. However, future bond returns more often approximate the available yield when purchased – not always, but a decent rule of thumb. If, as is often the case, an SAA is determined using historical performance, this may lead to a higher allocation to bonds as returns have been higher in the past. Currently, the Canadian bond universe yields 2.8%, materially below the historical average return (Chart 2). This could support an argument to lower the bond weighting—an option that isn't available in a SAA framework.

A SAA has many benefits including ease of use. It also reduces the risk of making an emotion-fuelled mistake. The negative is that it does not adapt to a changing market and so investors may miss any opportunities when valuations become elevated or depressed.

Tactical Asset Allocation: It isn't easy to be tactical. From an operational perspective, implementing tactical tilts requires more attention to markets and opportunities. There are two approaches that are most common, namely **discretionary** and **systematic**. A discretionary approach requires making asset allocation calls based on economic data, valuations, fundamentals and an overall market outlook. The most successful investors adopting this approach are: (a) typically contrarian, increasing weights in asset classes that are beaten down and out of favour; or (b) tend to reduce exposure to expensive asset classes that have some bubble characteristics. This does require a stronger internal fortitude to go against the herd, a behaviour that does not come easy as you're often wrong for a period before potentially being rewarded. You may lose a lot of clients being wrong for a year or two, even if proven right in the end. A discretionary tactical approach can open the door to behavioural mistakes, but it also allows the incorporation of expected asset class returns based on the current market environment and valuation.

A systematic approach uses rules to make tactical asset allocation tilts. The benefit of this approach is it can remove that emotional aspect, taking the investor "making a call" out of the equation. This reduces the risk of behavioural mistakes and provides clarity in the strategy. However, it makes implementing the strategy more difficult as it often requires a higher trading frequency.

Systematic approaches vary considerably; for instance, a strategy that uses relative valuations may allocate more/less to equities when inexpensive/pricey. Or this strategy can incorporate relative valuations across different equity and bond markets. This approach would be underweight U.S. equities currently given higher valuations. Another approach is momentum, attempting to tactically increase the weight in asset classes that are trending higher and decrease weights in those moving lower.

Chart 2: Most Static Asset Allocation models use long-term returns. With current yields being much lower, this may not be appropriate.

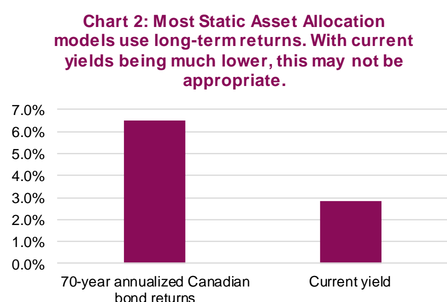

Table 1:

Static Asset Allocation	
Positives	**Negatives**
Ease of implementation	Ignores market opportunities and risks
Reduces risk of behavioural mistakes	

Discretionary Tactical Asset Allocation	
Positives	**Negatives**
Still pretty easy to implement	Need to be contrarian, which isn't easy
Can incorporate valuations, market environment	Rules are often vague
	Human behaviour-driven

Systematic Tactical Asset Allocation	
Positives	**Negatives**
Rules are clear, making it more persistent	Higher trading makes it more difficult to implement
Can incorporate valuations, market environment	May not be tax efficient due to trading.
Remove human emotion	

Conclusion

The right approach really depends on the investor and their source of advice. Sticking with a static approach does offer an easier path to implement – set-it-and-forget. Alternatively, some of the best investors in the world make tactical calls, but this approach also requires them to control their emotions and think outside the herd to be successful. Given the authors of this report manage a top-quartile tactical balanced strategy that uses a systematic approach, we have our preference.

Source: all charts are sourced to Bloomberg & Richardson GMP

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