The Rise of Tactical Asset Allocation

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The foundation of investment education for CFP® certificants is modern portfolio theory, which gives us tools to craft portfolios that effectively balance risk and return and reach the efficient frontier. Yet in his original paper, Harry Markowitz himself acknowledged that the modern portfolio theory tool was simply designed to determine *how* to allocate a portfolio, given the expected returns, volatilities, and correlations of the available investments. Determining *what* those inputs should be, however, was left up to the person using the model.

The evolution of the industry for much of the past 60 years since Markowitz's seminal paper[1] has been to assume that markets are at least "relatively" efficient and will follow their long-term trends, and as a result, to use historical averages of return (mean), volatility (standard deviation), and correlation as inputs to determine an appropriate asset allocation. Yet, the striking reality is that this methodology was never intended by the designer of the system itself; indeed, even in his original paper, Markowitz provided his own suggestions for how to apply his model:

> To use [modern portfolio theory] in the selection of securities we must have procedures for finding reasonable [estimates of expected return and volatility]. These procedures, I believe, should combine statistical techniques and the judgment of practical men. My feeling is that the statistical computations should be used to arrive at a tentative set of [mean and volatility]. Judgment should then be used in increasing or decreasing some of these [mean and volatility inputs] on the basis of factors or nuances not taken into account by the formal computations. …
> … One suggestion as to tentative [mean and volatility] is to use the observed [mean and volatility] for some period of the past. I believe that better methods, which take into account more information, can be found.

Thus, for most of the past six decades, we have ignored Markowitz's own advice about how to apply his model to portfolio design and the selection of investments—*not* to merely use long-term historical averages without modifying them based on judgment in attempt to recognize nuances missed by the formal computations. Through the rise of financial planning in the 1980s and 1990s, though, it didn't much matter. The extended 18-year period with virtually no material adverse risk event—except for one blip, the crash of 1987, which recovered within a year—suggested that long-term returns worked just fine, as they led to a stocks-for-the-long-run portfolio that succeeded unimpeded for almost two decades. Until it didn't.

As discussed in my paper with co-author Kenneth R. Solow, "Understanding Secular Bear Markets: Concerns and Strategies for Financial Planners," in the March 2006 *Journal of Financial Planning*, the year 2000 marked the onset of a so-called secular bear market—a one- or two-decade period when equities deliver significantly below average (and often, also more volatile) returns. The article predicted that the sustained environment of low returns would lead planners and their clients to question the traditional approach of designing portfolios based on a single, static, long-term historical average input (which leads to a buy-and-hold portfolio), and instead would turn to different strategies, including more concentrated stock picking, sector rotation, alternative investments, and tactical asset allocation. In other words, planners would find that relying solely on long-term historical averages without applying any further judgment regarding the outlook for investments, as Markowitz himself warned 60 years ago, would become increasingly problematic.

Trend Toward Tactical Steadily Growing

Although not widely discussed across the profession, FPA's latest *Trends in Investing* study[2] reveals that the rise of tactical asset allocation has quietly but steadily been under way and in fact now constitutes the majority investing style. Although not all financial planners necessarily characterize themselves in this manner, the study reveals that a shocking 57 percent of planners "recently (within the past six months) or are currently re-evaluating the asset allocation strategy [they] typically recommend/implement."

When asked what factors are being re-evaluated to alter the asset allocation strategy, a whopping 81 percent of respondents

indicate they are continually re-evaluating. Furthermore, 72 percent indicate they re-evaluate because of anticipated or existing changes in the economy in general, 37 percent watch for changes in inflation, and 40 percent monitor for changes in specific investments in the portfolio. Notably, only 11 percent indicate they expect to make changes based on what historically would have been the most popular reasons to change an investment, such as changes in cost, lead manager, or other administrative aspects of the investment.

Although not directly surveyed in the FPA study, another rising factor being used to alter investment allocations appears to be market valuation. This may be fueled by recent studies showing the value and effectiveness of the approach, including "Improving Risk-Adjusted Returns Using Market-Valuation-Based Tactical Asset Allocation Strategies" by Solow, Kitces, and Sauro Locatelli in the December 2011 *Journal*, and more recently, "Withdrawal Rates, Savings Rates, and Valuation-Based Asset Allocation" by Wade Pfau in the April 2012 *Journal*, along with "Dynamic Asset Allocation and Safe Withdrawal Rates" published in *The Kitces Report* in April 2009.

This emerging trend toward more active management doesn't necessarily mean financial planners are becoming market-timing day traders. According to the 2012 *Trends in Investing* study, the average number of tactical asset allocation changes that planners made over the past 12 months was two adjustments, and approximately 95 percent of all tactical asset allocators made no more than five allocation changes over the span of an entire year (and many of those changes may have been fairly modest trades relative to the size of the portfolio). In other words, planners appear to be recognizing that the outlook for investments doesn't change dramatically overnight; however, it does change over time and can merit a series of ongoing changes and adjustments to recognize that.

Tactical Asset Allocation an Extension of MPT

At a more basic level, though, the trend toward tactical asset allocation is simply an acknowledgment that it feels somewhat odd to craft portfolios using long-term historical averages that are clearly not reflective of the current environment. Examples are using a long-term bond return of 5 percent when investors today are lucky to get 2 percent on a 10-year government bond, or using a long-term historical equity risk premium of 7 percent despite the ongoing stream of research for the past decade suggesting that the equity risk premium of the future may be lower.

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Consistent with the idea that financial planners are recognizing tactical asset allocation as an extension of modern portfolio theory and not an alternative to it, 82 percent of financial planners who participated in the 2012 *Trends in Investing* study said they employ the basic assumptions of MPT in their investment strategies for clients. Although MPT may still work, many of us lack the training in new and better ways to apply it. Nonetheless, that hasn't stopped the majority of planners from adopting a process for making ongoing changes to their asset allocation based on economic outlook and other similar factors.

Unfortunately, though, perhaps the greatest challenge for planners implementing tactical asset allocation is that we simply aren't trained to do so in our standard education. Some financial planning practices are responding to this challenge by investing in training, staff, and/or research to support a more tactical process. Others are responding by outsourcing to firms that can help. The 2012 *Trends in Investing* study shows that 42 percent of advisers are outsourcing investment management. And we know from last year's *Trends* study that 38 percent of advisers were outsourcing more in 2011 than they were in 2010.

Regardless of how it is implemented, the trend toward tactical itself appears to have grown from a broad dissatisfaction among planners and their clients that the "lost decade" of equity returns has left many clients lagging their retirement goals. Even if diversified portfolios have eked out a positive return, it is still far behind the projections put forth when clients made their plans in the 1990s, forcing them to save more, spend less, or work longer to make up for the historical returns that never manifested. And as long as the secular bear market continues, the strategy will continue to be appealing. Ultimately, though, the sustainability of the tactical asset allocation trend will depend on it delivering effective results for clients.

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Endnotes

1. Markowitz, Harry. 1952. "Portfolio Selection." *Journal of Finance* (March).
2. FPA 2012 *Trends in Investing* study of 378 financial advisers, fielded in February. Results reported are statistically valid at a 95 percent confidence level with a +/– 5 percent margin of error, and are representative of the FPA membership.