Defining 'Tactical Asset Allocation'

By Editor Test *Sun, Jul 1, 2012*

Many advisors feel unprepared to allocate assets tactically, and a recent Journal of Financial Planning article shows a growing trend over the past three years toward advisors outsourcing their investment management chores and letting someone else figure it out.

FPA's 2012 Trends in Investing study found that a majority of advisors have become tactical asset allocators, according to "The Rise of Tactical Asset Allocation" by Michael Kitces in the *Journal of Financial Planning*.

This doesn't mean advisors are abandoning the principles of MPT—far from it. But they are less willing to base their allocation decisions on historical averages (such as the 5% from long-term bonds) that no longer apply.

Tactical allocation doesn't necessarily contradict MPT, Kitces points out: "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."

Advisors are turning to different strategies, including concentrated stock picking, sector rotation, alternative investments, and market valuations. But they're hardly day-traders. The advisors in the study made no more than about five allocation changes a year. Nonetheless, many advisors feel unprepared to allocate assets tactically, and the study shows a growing trend over the past three years toward advisors letting someone else figure it out by outsourcing their investment management chores.

In a related article about the Trends in Investing study, Brad McMillan recommends allocating 15% to 25% of a portfolio's assets to alternative investments. Managed futures, long/short funds and even so-called "go anywhere funds"—though these are hard to define, let alone rely on—can diversify a portfolio by providing non-correlated returns.

"There are two ways to do this," McMillan wrote. "First, find an asset class that is largely under-owned, where the perception (but not the reality) is that it's too dangerous or otherwise undesirable for most people. The second way is to find a strategy that will work in a non-correlated way by design."

Since most asset classes have been so finely sliced and diced by size and geographic region, it's preferable to look at diversifying strategies such as long-short and absolute return and assets such as Business Development Companies. Of course, as "weird and scary" investments become more popular they lose their value to diversify.

"The lessons are the same as for any traditional asset class," writes McMillan. "Pay attention to valuations; watch for bubbles; make sure you understand the strategies, risks, and expected results; and always be aware of where the asset class is in the popularity cycle, as that will help determine the potential for alpha."