

# the tortoise & the hare



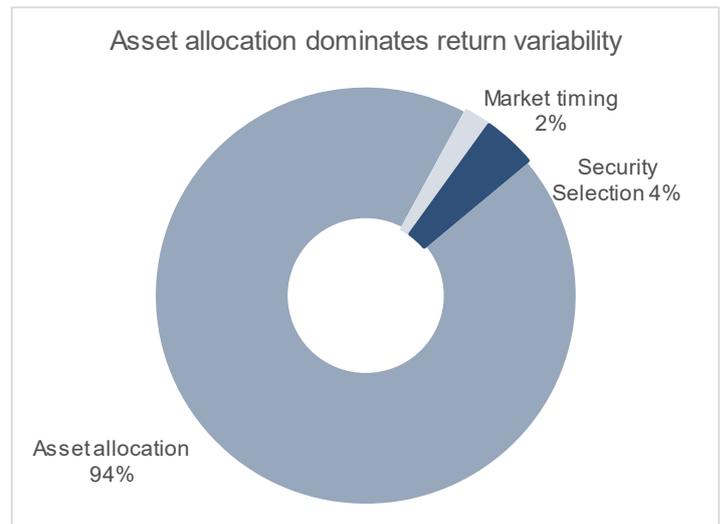
## | Getting Tactical About Asset Allocation

The question we find ourselves asked the most frequently is: Should I sell US equities? It is a very good question, but it is also too narrow. Many investors agree that US equities are expensive and as a result of this believe the allocation should be reduced versus the strategic target. From a valuation point of view this is a good idea, as by most measures, such as the price to book (P/B) or the Shiller P/E ratio (also called CAPE = cyclically adjusted P/E), US equities versus their own history have reached lofty valuation levels. At the same time many investors overlook questions such as:

1. How do you size a portfolio underweight in US equities?
2. Should information beyond valuations be considered?

Before we address each of these questions, let's revisit the basic facts on asset allocation. Asset allocation is broadly understood as the exercise of allocating between different asset classes, such as bonds versus equities, and different market segments, such as UK bonds versus Eurobonds. Holding any asset allocation for a long period of time is called strategic asset allocation (SAA). SAA has a huge impact on the return outcome as well as the return variability, also known as volatility. A famous study by Brinson, Hood and Beebower<sup>1</sup> examines determinants of portfolio performance and its volatility. The key point to take away is that SAA on average determines over 90% of the return volatility.

This is demonstrated in the following graph.



Corresponding results have since been confirmed by similar studies by Brinson et al<sup>2</sup>. A study by Ibbotson and Kaplan into the impact of SAA on the return level<sup>3</sup>, shows that empirically SAA was on average responsible for 100% of the return level outcome.

Nowadays more and more investors focus their investment efforts on SAA and implement it with cheap, passive index tracking products. For the average retail investor this is a smart choice. So should we do the same at MASECO?

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It is important to note that on average both market timing and security selection can lead to higher performance levels, given that each has very little impact (2% and 4%) on the total volatility of the return outcomes.

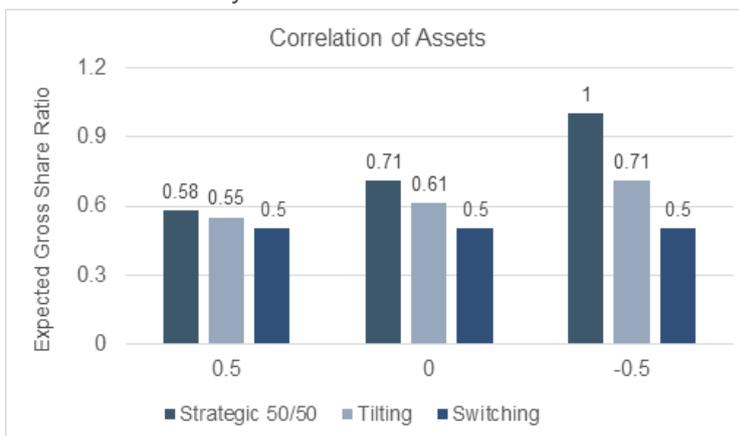
Both market timing and security selection represent active investment management. Market timing represents short term, tactical asset allocation (TAA) decisions, like temporarily underweighting US equities versus the strategic US equity allocation. Security selection keeps the strategic US equity allocation but varies the weights of individual US stocks within the allocation to US equities.

For a long time we have expressed our convictions surrounding security selection. At MASECO Private Wealth we believe there is a chance to outperform by pursuing cheap, systematic investment strategies that are based on academic, empirical evidence and that attempt to exploit return premia motivated by either risk, investor behaviour or structural impediments. For the remainder of this article I will therefore re-focus on tactical asset allocation.

TAA is traditionally implemented by tilting portfolios away from strategic weights during any year. This creates relative risk (tracking error) but also potential outperformance (excess return) versus the SAA portfolio. The relationship of both variables, excess return over tracking error, is measured by the information ratio, and the aim of TAA is for the information ratio to be positive. A 10% underweight creates a much higher tracking error than a 2% underweight but if the same idea is applied (the same information ratio), there is potential for higher outperformance. Therefore, investors are required to have a very clear idea about how much tracking error they can withstand when markets don't behave as predicted and that TAA generates significant underperformance versus a pure SAA portfolio.

Sizing an under or overweight portfolio can have further implications on the absolute level of risk. For example, if an investor doesn't like bonds versus equities because of low yield, should they reduce bonds from 50% strategically to 25% tactically? Alternatively, should the investor go all the way and not allocate to bonds at all; in other words switch to 100% equity? The latter will cause a less diversified portfolio i.e. risk will increase and the expected Sharpe ratio will drop. In fact, all tilts away from a strategic allocation incur a mechanical Sharpe ratio penalty - the bigger the tilt the higher the penalty.

As the following graph illustrates the penalty is also larger for portfolios with more diversified assets or strategies (lower correlations) with a 50/50 combination of two hypothetical assets, which both have a Sharpe ratio of 0.5 and a volatility of 10%<sup>4</sup>:



Therefore the reason to perform TAA has an uphill battle just to match the Sharpe ratio of the SAA portfolio. As the graph below demonstrates, an investor must get more than 7 out of 10 ideas right (70% hit ratio) to overcome the diversification loss of switching from a 50/50 weighting to 100% in just one of the two negatively correlated assets. This would be a rare and outstanding result for any investor<sup>4</sup>.



In summary, rather than aiming so high, it might be better to pursue the alternative - to not perform any TAA between negatively correlated assets. Or, put more simply, don't mess with the bond/equity split (negative correlation) and only take modest tracking error risk.

Focusing now on the return outcome of TAA, it is worth revisiting the "Fundamental Law of Active Management"<sup>5</sup> formula. Let's, for example, assume two investment strategies have a very desirable expected information ratio (IR) of 0.5. They are expected to generate 2% of outperformance per annum with a tracking error of 4%.

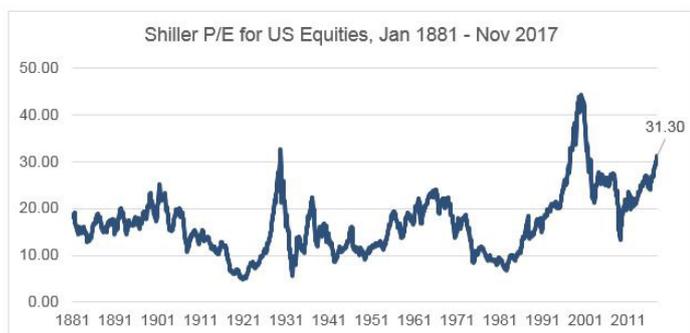
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The law explains that the two investors might achieve that same result in very different ways: one with many ideas but only some skill, the other with limited ideas but a significant amount of skill. The former could be a systematic equity strategy with a very large investment universe of hundreds of stocks. The latter could be a TAA strategy that pursues a typical allocation between different equity regions such as Emerging Markets, Japan, UK, Eurozone and the US. In these scenarios, the TAA investor would have to be far more skilled than the equity investor to achieve a similar outcome!

Lastly, let's look at using valuations in TAA decision making. In my opinion it is an absolute necessity to consider valuations. However, looking only at valuations can be equally as disastrous. For instance, some of you may remember the 'TMT bubble' at the turn of the century.

The below graph displays the Shiller P/E for US equities for the period of January 1881 to November 2017. In December 1995 US equities reached a Shiller P/E level over 25, well above the average level of about 15, which any investor could have calculated from all the data history between 1881 and 1995. 25 was also a level achieved only twice before in a period longer than 100 years.

Unsurprisingly in 1995 some investors believed that US equities were expensive and therefore started reducing their allocations to US equities. Unfortunately, in the following four years these investors had to experience significant performance headwind as valuation levels climbed even further!



After reading all of this, how excited are you about MASECO executing TAA? Most likely not a great deal. Nonetheless, we have started to do it but in a very different, modern way that until now has predominantly been pursued by sophisticated, institutional investors. It involves the following:

Traditional	Modern
Long-only	Long/short
Unlevered	Leveraged
Equity dominated	Diversified
Single factor	Multi-factor
Single geography	Global
Single asset class	Multi-asset

I look forward to sharing and explaining more details in my next article.

## Sources

- 1 Brinson, G., Hood, R., and Beebower, G., (1986) "Determinants of Portfolio Performance", *Financial Analysts Journal*, vol. 42, No. 4, pp 39-44.
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- 4 AQR, "Alternative Thinking", Fourth Quarter 2014
- 5 Grinold, Richard C., 1989. "The Fundamental Law of Active Management," *The Journal of Portfolio Management*, 15(3), 30–38.
- 6 Online Data Robert Shiller:  
<http://www.econ.yale.edu/~shiller/data.htm>

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