MASECO PRIVATE WEALTH

the tortoise & the hare

Improving The Odds

Our last Investment Newsletter finished with very little light at the end of the tunnel, but today we provide a detailed description of the kind of modern tactical asset allocation (TAA) we embrace and pursue with the help of fund vehicles.

Before we go into detail on each of the characteristics, the table below provides a contrast between old style TAA and institutional style modern TAA.

Traditional	Modern
Long-only	Long/short
Unleveraged	Leveraged
Physical Implementation	Derivative Implementation
Single factor	Multi-factor
Single geography	Global
Single asset class	Multi-asset

Modern TAA combines many characteristics that all serve the main objective: to improve risk-adjusted returns. To achieve this objective, modern TAA strategies are much more diversified. Gone are the days where a manager just shifts money between a few major equity markets or simply allocates between US equities, US bonds and US cash.

Nowadays, TAA strategies explore global equity markets in much greater detail as they trade on country or regional equity indices from around the world, including liquid emerging markets. In bonds, futures on different parts of a yield curve are traded. Some strategies even explore credit spreads. Additionally, modern TAA strategies allocate between different commodities, from energy contracts to agricultural, precious and industrial metals. They also pursue investment decisions between currency pairs, often including currencies from emerging market countries. Some TAA strategies even trade volatility. Needless to say, modern TAA strategies have many options in which to invest.

All these investments are pursued using derivatives. What sounds intimidating to an investor who has little experience with derivatives, is music to the ears of sophisticated, institutional investors around the world. Most of these derivatives have been used by investors for decades and many of them are standardized instruments. They bring substantial cost advantages, as liquidity in most derivatives is very deep, sometimes even deeper than the physical market they are linked to. The crucial advantage here is that trading costs are relatively low, which in turn allows a manager to trade more frequently.

Derivative usage also allows TAA investors to 'short' a market. This means that if the investment thesis assumes that the price will fall, establishing a short position makes it possible to turn such an idea into a profitable strategy. In the previous Investment Newsletter I mentioned the "Fundamental Law of Active Management". In this I explained that if you take a skilful manager and lift the constraint to only invest in ideas based on rising prices, you can double the number of ideas one can implement. This has a big impact on the return that can be achieved from each unit of risk a manager has been mandated to target!

Now let's talk about leverage. While leverage can often be a polarising topic, we believe there is a strong case to apply it to achieve superior risk management. Let's assume somebody wants to establish a balanced (50/50) split of their assets, which in risk terms is a highly sensible idea. Let's also assume that this same person likes both US equities and US fixed income and that this person can afford to take a level of risk equivalent to typical equity risk.

Is it possible to achieve all these objectives? Not without leverage! Without leverage one would have to hold 80% in bonds and 20% in equities to have a balanced split in risk terms (20% * 4 = 80% * 1), assuming that equity risk is four times as high as bond risk. Of course, this type of portfolio would be a long way from exhibiting the total risk level that a hypothetical investor is comfortable with.

However with leverage, and for simplicity excluding correlations, the investor could be invested 50% in equities and 200% in bonds. These position sizes would not only result in a balanced risk between bonds and equities (50% * 4 = 200% * 1) but also achieve their objective for total portfolio risk to be equivalent to equity risk.

If an investor wants to have a noticeable impact on overall portfolio returns, modern TAA strategies would need significant portfolio allocations. Without leverage, they are only able to target a volatility level similar to typical bond volatility. Instead, because they can apply leverage, some modern TAA strategies target a risk level nearly as high as equity risk. This allows investors allocating to them a much greater degree of capital efficiency, as they can make much smaller allocations whilst still achieving a sufficient level of risk-adjusted return impact.

Lastly, modern TAA strategies no longer focus all their attention on valuations. Instead, they are multi-factor strategies that also seek to benefit from momentum, quality and/or low risk as well as carry concepts. Below is an explanation for each idea:

Value – The tendency for relatively cheap assets to outperform relatively expensive ones

Momentum – The tendency for an asset's recent relative performance to continue in the future

Carry – The tendency for higher-yielding assets to provide higher returns than lower-yield assets

Quality, Low Volatility (Defensive) – The tendency for lower risk and higher-quality assets to generate higher risk-adjusted returns than high risk and low quality assets

Going into more detail on each of these may be a topic for future articles. At this stage it is critical to understand that a multi-factor approach is introducing an additional layer of diversification beyond the multi-asset dimension. This makes the return stream from modern TAA strategies even more robust.

I hope that after reading this article you can see the light at the end of the tunnel. No investment strategy can claim to be the 'Holy Grail' of investing as each strategy will undoubtedly have patches of negative performance - modern TAA strategies are no exception. However, I am confident that these institutional style, sophisticated strategies are a useful tool to improve the odds of long-term positive returns to our investors.