INVESTING EVOLVED

Finding Returns in Falling and Rising Markets

The Investing Evolved framework focuses on diversification of not only asset classes, but also strategies. One component of the framework is the use of tactical strategies; but what does it mean to be tactical and how might they be used in a portfolio?

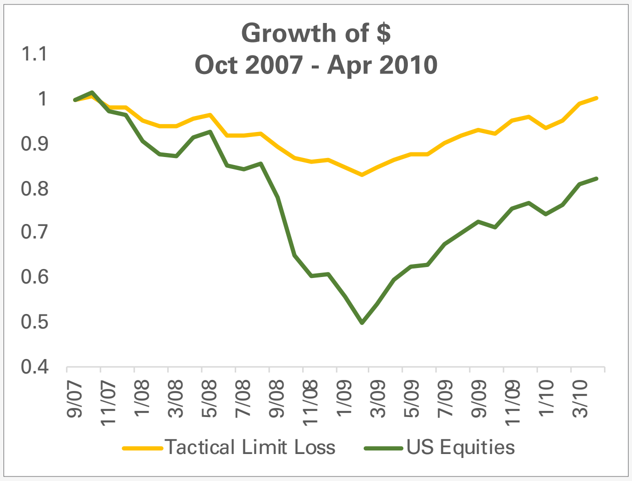
Tactical Strategies

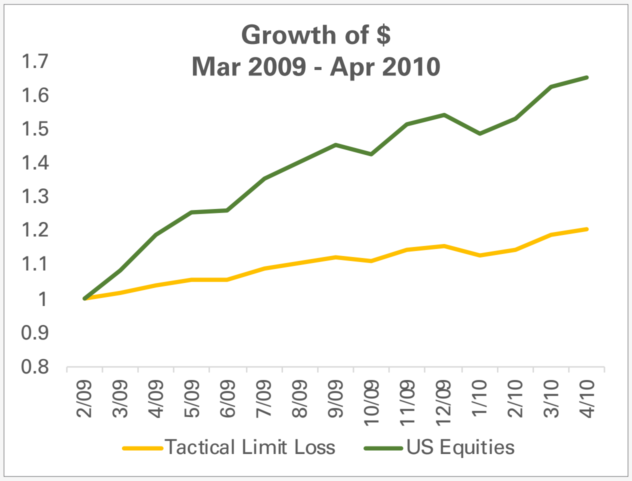
Tactical strategies are a way to provide additional sources of return into a portfolio through active management. Tactical, or active management, doesn't just mean there is a lot of trading and turnover in the portfolio, it could mean that the portfolio is going to look very different from a traditional diversified benchmark with concentrations in certain sectors or industries.

Tactical strategies can be thought of as tools to help with some of the emotions that come with investing over the long term. In market declines, investor emotions are running high as portfolio values are declining with the market downturn. Tactical Limit Loss strategies can help ease those emotions by being able to adjust how much equity exposure they hold and subsequently limiting their participation on the downside. In market rallies, investor emotions also run high if portfolio values are not keeping up with the market. Tactical Enhanced Return strategies seek to help during these times, as they are typically fully invested in the equity market and make decisions to take targeted exposure to specific sectors, industries or regions.

Tactical Limit Loss

Tactical Limit Loss strategies adjust their equity exposure based upon a proprietary signal that indicates the level of risk in the market. As market risk rises, Tactical Limit Loss strategies reduce their equity exposure, and as market risk falls, the strategies increase their equity exposure. By reducing exposure to equities as they fall, the strategy typically doesn't fall as much as the market and subsequently doesn't take as long, or need as much return, to recover (see chart Growth of $ Oct 2007 – Apr 2010). However, because these strategies are reactive to, rather than predictive of market risk, they tend to lag following the turning point of the market as they readjust their equity exposure (see chart Growth of $ Mar 2009 – Apr 2010).



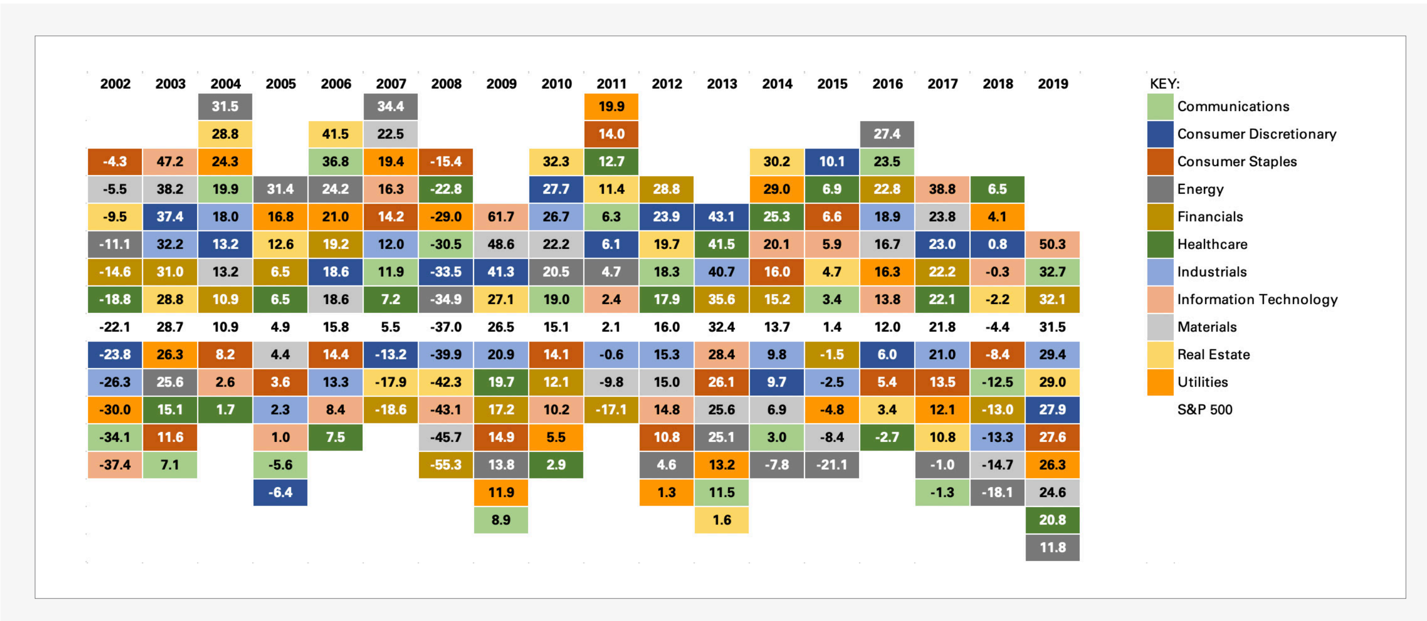


Source: Zephyr Style Advisor

The charts above show the returns of the index we use to represent Tactical Limit Loss strategies, the S&P 500 Daily Risk Control 10% index, alongside US equites, represented by the S&P 500. From the peak of the market in 2007 to the bottom in 2009, shown in the first chart, we can see how the Tactical Limit Loss strategies did not fall as much, a result of equity exposure being reduced from 65% to 21%. By reducing the drawdown, the strategy was able to recover to a breakeven point much more quickly than US equities. But the Achilles heel with these strategies, as shown in the second chart, is that they typically don't keep up with the market as it rebounds. The Tactical Limit Loss equity exposure is significantly lower at the turning point and will not be able to keep pace with the market. Over this time tactical limit strategies tend to be adjusting equity exposure higher, and equities rose from the 21% in March 2008 to 84% in April 2010.

Tactical Enhanced Return Strategies

In contrast, Tactical Enhanced Return strategies tend to target specific sectors, industries, factors, regions or countries and rotate exposures over time based on their outlook. Exposures could be taken based on relative valuations measures, consideration of economic or business cycle, or return potential based upon the trend in prices.



2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
		31.5			34.4				19.9								
		28.8		41.5	22.5				14.0					27.4			
-4.3	47.2	24.3		36.8	19.4	-15.4		32.3	12.7			30.2	10.1	23.5			
-5.5	38.2	19.9	31.4	24.2	16.3	-22.8		27.7	11.4	28.8		29.0	6.9	22.8	38.8	6.5	
-9.5	37.4	18.0	16.8	21.0	14.2	-29.0	61.7	26.7	6.3	23.9	43.1	25.3	6.6	18.9	23.8	4.1	
-11.1	32.2	13.2	12.6	19.2	12.0	-30.5	48.6	22.2	6.1	19.7	41.5	20.1	5.9	16.7	23.0	0.8	50.3
-14.6	31.0	13.2	6.5	18.6	11.9	-33.5	41.3	20.5	4.7	18.3	40.7	16.0	4.7	16.3	22.2	-0.3	32.7
-18.8	28.8	10.9	6.5	18.6	7.2	-34.9	27.1	19.0	2.4	17.9	35.6	15.2	3.4	13.8	22.1	-2.2	32.1
-22.1	28.7	10.9	4.9	15.8	5.5	-37.0	26.5	15.1	2.1	16.0	32.4	13.7	1.4	12.0	21.8	-4.4	31.5
-23.8	26.3	8.2	4.4	14.4	-13.2	-39.9	20.9	14.1	-0.6	15.3	28.4	9.8	-1.5	6.0	21.0	-8.4	29.4
-26.3	25.6	2.6	3.6	13.3	-17.9	-42.3	19.7	12.1	-9.8	15.0	26.1	9.7	-2.5	5.4	13.5	-12.5	29.0
-30.0	15.1	1.7	2.3	8.4	-18.6	-43.1	17.2	10.2	-17.1	14.8	25.6	6.9	-4.8	3.4	12.1	-13.0	27.9
-34.1	11.6		1.0	7.5		-45.7	14.9	5.5		10.8	25.1	3.0	-8.4	-2.7	10.8	-13.3	27.6
-37.4	7.1		-5.6			-55.3	13.8	2.9		4.6	13.2	-7.8	-21.1		-1.0	-14.7	26.3
			-6.4				11.9			1.3	11.5				-1.3	-18.1	24.6
							8.9				1.6						20.8
																	11.8

Source: Zephyr Style Advisor

The chart above ranks the sectors for each year from the best performing to the worst and shows which sectors outperformed the S&P 500 and which ones underperformed. It's clear to see there is little consistency in the top-performing sectors and the range of outperforming returns that could be possible for an active manager who can rotate across sectors.

While Tactical Enhanced Return strategies could outperform a broad index in both positive and negative markets, the role in the portfolio for these strategies is really to add value during market rallies. Having exposure to the markets and seeking to add value over a broadly diversified index through their active management should provide a boost to returns as markets rebound.

Takeaways

Tactical strategies should complement your core portfolio of equities and fixed income; their role in the portfolio is to offer additional sources of return for different market environments. Tactical Limit Loss strategies are designed to limit losses during falling markets while Tactical Enhanced Returns are designed to take advantage of rising markets. Since we don't know when the market will rise and fall, we believe these strategies should be a consistent part of a long-term, goals-based portfolio.

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