

Strategic & Tactical Asset Allocation

Your guide

Introduction

As an investor, nothing is more important than determining your financial goals. After all, achieving your aspirations is the reason you invest.

You must then assess how much risk you are willing and able to take to achieve them. A good understanding of the fundamentals of investing and guidance from a Financial Adviser will help you establish a clear goal-driven financial plan.

Once your plan is in place, you need to consider achieving the right mix of investments to provide the best chance of realising your ambitions with minimum risk. This will involve creating an optimum blend of assets. These generally include Cash, Bonds, Property, Equities and maybe some alternative assets, such as Commodities. Getting this asset allocation right is crucial to fulfilling your financial plans. It's the map that will guide you to your goals.

When establishing your asset allocation, professional investment managers adopt two common approaches: strategic and tactical. Each has its merits. So which strategy or mix of approaches you adopt is your decision. This document aims to help you choose wisely, providing an unbiased view of each strategy based on what we believe are generally accepted opinions.

Strategic Asset Allocation

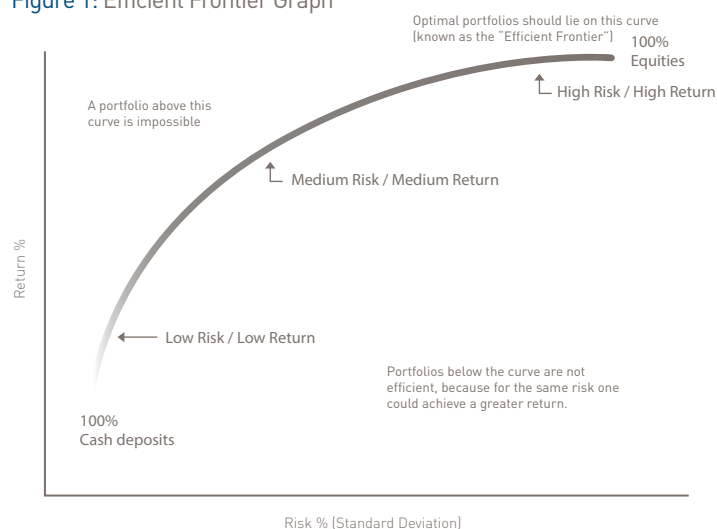
Strategic asset allocation involves defining and fixing portfolio asset allocations from the outset, based on historical performance data. This strategy follows the principles of Modern Portfolio Theory: a pioneering work that saw Harry Markowitz win a Nobel Prize in 1990.

Managers adopting this approach do not usually exploit short-term opportunities. Instead, they rely on historical data to indicate long-term performance. When creating the portfolio, managers establish an asset mix based on the expected risk and return dynamics of each asset class. A wealth of historical statistical data shows how asset classes have performed during many social, political and economic conditions. Managers use

significant resources to review this data, focusing on the long-term returns and risks within each asset class. Using this analysis, they create portfolios that provide the best balance of risk and reward. Portfolios fitting tightly to the Efficient Frontier are termed 'Efficient' because they aim to achieve the highest possible expected rate of return for the level of risk within the asset mix.

Figure 1 below shows the relationship between risk and return as you move along the Efficient Frontier. While a portfolio above the Efficient Frontier is mathematically impossible, a portfolio below the curve is not. In fact, it is common in many do-it-yourself portfolios.

Figure 1: Efficient Frontier Graph



Source: Modern Portfolio Theory, Harry Markowitz (1990).

Holding a portfolio not professionally mapped to the Efficient Frontier could mean you inadvertently take a higher degree of risk than the potential return warrants. This goes against the rules of risk and return, which expect maximum returns for the risk you are taking. An almost infinite number of strategic portfolios are available to investment managers. So they will provide each investor with portfolios tightly mapped to the Efficient Frontier. This offers the best chance of achieving a desired return at the lowest possible risk.

After establishing a strategic asset allocation, the investment manager will not deviate from the original determined asset weights. They focus on preserving the fixed weights because they ultimately relate to a larger performance objective based on historical data.

To preserve the portfolio's integrity, asset class mixes are usually rebalanced to the target weights at regular intervals, such as quarterly or half yearly. This keeps the asset allocation aligned with the long-term goal. The process of rebalancing involves selling those assets that have performed the best and repurchasing those assets that have under-performed, retaining the integrity of the original asset allocation.

Tactical Asset Allocation

In its most simple form, tactical asset allocation adopts the fixed-asset weightings of a strategic portfolio. However, it also gives investment managers the flexibility to vary those weightings in a risk-controlled frame work.

Professional investment managers seek to create an additional source of return by moving among the asset classes. They aim to take advantage of short-term market inefficiencies and manage investors' exposure to risk. These costs must be recovered in additional gains before the tactical manager can demonstrate outperformance against a strategic portfolio.

Managers normally do this by evaluating the relative attractiveness of Cash, Bonds, Property and Equity markets through financial valuation, growth and sentiment measures. They will then use a systematic process to assess the current attractiveness of those classes and alter the portfolio weightings accordingly.

Tactical investment philosophy is usually based on the belief that markets are not efficient. Investor psychology and market forces can lead to periods of incorrect asset-class valuations. Tactical asset allocation attempts to capture these inconsistencies. It is not a fixed-weight asset mix and a portfolio's allocation and risk level may change within the parameters set out in the risk mandate.

Which strategy is best?

This is hotly debated between advocates of each strategy. Both sides accept your overall strategic asset allocation significantly affects the returns you achieve long term. However, they diverge on how to manage that allocation in the short term.

Advocates of strategic asset allocation argue that, over the long term, asset classes will perform as expected and that adjusting them in the short term is equally likely to end in failure as success. So they promote keeping the asset mix in line with the investor's long-term goals and striving to retain this blend through rebalancing.

The debate focuses on the tactical manager's ability to identify short-term inconsistencies in asset prices and exploit them for the investor's benefit. This could mean reducing a weighting in an asset class they believe is overpriced – and buying into an asset class they think is underpriced or fairly priced. The aim is to provide a gain potential above that of strategic asset allocation.

However, while the manager has the flexibility to generate outperformance, choosing incorrectly risks under performance.

Tactical managers strive to identify market inefficiencies and make calls that provide outperformance opportunities. However, this strategy involves significant ongoing research and associated costs. These costs must be recovered in additional gains before the tactical manager can demonstrate outperformance against a strategic portfolio.

Managers structure strategic and tactical portfolios to achieve returns for particular risks. One strategy will not necessarily offer a better return or less volatility than the other over the longer term. However, each approach is easy to understand and can be followed using a goal-orientated discipline that reflects a structured financial plan.

In Summary

Strategic asset allocation - may be right for you if you like to keep things simple. It may also be appropriate if you don't feel comfortable with the additional costs of tactical asset allocation and no guarantee of outperformance.

Tactical asset allocation - may appeal because you might want to take more of an interest in your portfolio. You could be comfortable knowing that, in times of market turbulence, your fund manager is trying to reduce risk and increase returns for you.

Each strategy has its merits. No two investors are the same. So the choice between strategic and tactical is yours.

This document provides information about investing and explains some of the different strategies available to you. It is a statement of opinion and you should not take it as an indication of future likely returns. Seeking professional advice will help you make informed decisions that are right for you.



Harley Financial Services
Chartered Financial Planners
20 Meeks Road
Falkirk, FK2 7ES.

T: 01324 625 225

E: info@harleyfinancial.co.uk

W: www.harleyfinancial.co.uk