Global Tactical Asset Allocation: One Strategy Fits All?

Global tactical asset allocation (GTAA) is a flexible strategy implemented through myriad asset classes and approaches. GTAA funds are designed to offer risk reduction, uncorrelated returns, and liquidity. The variety of funds and short performance track records make it difficult for investors to assess these funds on a relative basis. Investors adopting a GTAA strategy will fare best if they also adopt a contrarian mindset.

“There’s always something interesting to invest in. Always.”
— Rob Arnott, Research Affiliates, LLC

With US equities and bonds at pricey levels and hedge funds disappointing in recent years, investors are seeking downside risk protection and alternative sources of return. Global tactical asset allocation (GTAA) funds have captured investor attention because of the strategy’s objective to diversify and limit risk. GTAA funds tactically shift among asset classes to focus on discounted assets and avoid assets that are overpriced. The appeal of GTAA lies in its potential to weather an array of economic and market environments to deliver uncorrelated returns. After the financial crisis of 2008, the flexibility of such a strategy became more attractive to investors, and the number of GTAA products has grown significantly in the past five years. Through the second quarter of 2013, institutional fund database provider eVestment tallied 18 consecutive quarters of net inflows into GTAA funds. “Industry-wide, there’s been a big demand for liquid alternatives,” says Adam Blake, managing director of Hartland & Co., an independent investment consulting firm.

THE CHAMELEON STRATEGY

As a strategy, top-down tactical asset allocation (TAA) is certainly not new. In its earliest days, TAA shifted exposures among stocks, bonds, and cash. The limited investment choices and difficulty in successfully timing investment bets generally led to poor performance relative to strategic asset allocation. GTAA strategies evolved as the universe of investable assets expanded to include other countries and alternative asset classes.

A key premise underlying GTAA is that developed markets have become efficient at the level of individual securities but are inefficient at the asset class level on a global basis. Moreover, risk premiums are constantly shifting. “They shift every day and every minute of every day,” says Rob Arnott, chairman and CEO of Research Affiliates and manager of the PIMCO All Asset and All Asset All Authority funds. GTAA strategies seek to invest in asset classes that have favorable risk premiums and avoid asset classes where risk is overpriced. Tactical decisions are generally expected to pay off over a period of one to three years rather than weekly, monthly, or quarterly. GTAA managers have the flexibility to invest globally in assets with attractive risk-and-return profiles and are able to respond more quickly to changes in markets than a plan sponsor’s strategic mandate allows. Many GTAA strategies invest in alternative assets that small investors are prohibited from accessing because of size or cost.

GTAA’s flexible mandate resembles the hedge fund strategy known as global macro, but GTAA funds differ from hedge funds in several significant ways. GTAA funds are generally liquid, long only, and do not use leverage. The strategies can be implemented through index products, actively managed funds, actual securities, and frequently, derivatives. GTAA managers do not charge performance.
fees, and the use of liquid, inexpensive futures, options, and swaps allows for much lower management fees than hedge funds charge. Because GTAA funds are more liquid than hedge funds, they are able to move more quickly to establish or shed positions. “If you compare those strategies to hedge funds, you get similar results and similar volatility but it’s done with liquid investment vehicles,” says Blake. GTAA strategies are also sometimes confused with risk parity strategies. Risk parity strategies strive to maintain a particular risk profile, and often use leverage, whereas GTAA strategies attempt to provide downside protection through diversification and tactical allocation.

GTAA strategies are typically not intended to replace an investor’s strategic asset allocation but to complement it. GTAA strategies can also be implemented as overlay strategies. A wide variety of GTAA funds exist; they differ according to asset class universe, method of implementation, and the timing element, among other factors. A GTAA strategy may focus on unconstrained access to equities, fixed income, or an equity/fixed blend or provide access to traditional and alternative asset classes. “GTAA is a bit of a chameleon strategy. It can fit a variety of roles,” says Arnott. “GTAA investors need to know what they are looking for. Are they looking for a strategy that will swing between their stocks and bonds or one that will predominantly anchor their stocks and bonds? Or do they want something that focuses on diversifying away from stocks and bonds?”

For traditional portfolios dominated by equity and fixed-income risk, GTAA funds that provide access to alternative investments such as commodities and real estate can be a good source of diversification. GTAA funds may share similarities with traditional or alternative asset classes, though they are not direct substitutes for either. Blake uses GTAA strategies as a complement to clients’ fixed-income allocations. “In the last few years, we have been viewing these more conservative alternatives and fixed income not as a one-for-one trade-off but as vehicles that can produce some of the historical fixed-income characteristics that we may not get in the future, given where interest rates are today.”

**BEST PRACTICES IN EVALUATING GTAA MANAGERS**

When evaluating a GTAA manager, investors should understand the benefits and risks of the strategy in general as well as for the particular manager. Although part of the appeal of GTAA strategies is their low correlation with other asset classes, some GTAA strategies may be highly correlated with mainstream stocks and bonds. In particular, this issue applies to GTAA funds focused on equities or bonds because asset subclasses are more highly correlated than overall asset classes. Another primary benefit of GTAA strategies is that they provide low-cost access to alternatives, which allows them to keep fees modest relative to hedge funds. Some GTAA strategies may invest in asset classes that lack low-cost access, however, resulting in higher fees that reduce the cost benefit to investors.

Because of the vast differences in exposures and in asset classes used, evaluating the relative success of GTAA strategies is difficult. GTAA managers use an array of benchmarks; no universal passive index exists that all GTAA managers can be compared with. Some GTAA strategies have an absolute return benchmark, whereas others benchmark to a passive 60% equities/40% fixed income portfolio. Investors seeking exposure primarily to alternatives might compare a GTAA fund’s performance with an index of global macro hedge funds. Investors seeking diversified equity exposure might compare performance with the MSCI World Index. Rich Donnellan, product manager in research at eVestment, says that despite the array of benchmarks and funds, consultants and investors often evaluate GTAA funds by ranking them against their peers using a standard benchmark, such as the 50% MSCI World/50% Citi WGBI (World Government Bond Index). Comparing a particular GTAA strategy with a broad peer group tends to be less useful than for other investment strategies.

Assessing historical performance is further complicated by the relatively short track record of many GTAA strategies. “Some of the oldest liquid tactical strategies only have about ten years of history,” notes Blake. If possible, funds should be evaluated during different market events or cycles to see if they have performed as the manager intended them to, particularly those funds that were in place during or prior to the financial crisis. Investors should also know the time horizon over which a manager reasonably expects the strategy to outperform. Many strategies are designed to outperform over one to three years; the tactical element may not be as short term as an investor might think.

To evaluate risk-adjusted performance, the Sharpe ratio is frequently used because it facilitates comparison among different types of funds or strategies. The information ratio can be used to compare GTAA funds with the same benchmark, though investors may find
relatively few funds that share a benchmark. Upside/downside market capture is also a performance metric of interest to GTAA investors. “Many of these strategies are seeking absolute return in any market,” Donnellan says. “Investors want to know how the manager performed relative to the market in good markets versus bad.”

A July 2013 study by Marquette evaluated GTAA funds with $100 million or more in assets over a five- and ten-year time frame. The study compared the performance of a median GTAA fund with that of a 60/40 benchmark chosen as a low-cost portfolio alternative. Of the total number of pure GTAA products in the eVestment universe, 83% had a five-year record but only 37% (19 funds) had a ten-year record. The median GTAA manager underperformed the passive 60/40 portfolio over the one-year, three-year, and five-year horizons through December 2012, net of fees. Ten-year performance statistics were considerably better—approximately half of the GTAA managers outperformed the benchmark. Results for the top managers were even more favorable. Top managers outperformed the 60/40 portfolio for all four time horizons.

The Marquette study also highlighted some trends in GTAA fund performance. A large dispersion in returns was found between top- and bottom-quartile managers. Performance was also found to be positively correlated with firm size. A possible reason is that large firms have more resources to facilitate global investments. In addition, the study called into question the willingness of managers to be as flexible as such a strategy dictates. Conservative managers tended to perform well in periods of crisis, whereas aggressive managers performed well during bull markets. Neither group of managers seemed to shift from conservative to aggressive postures and vice versa during periods when these shifts would have benefited performance.

As with any investment strategy, investors will want to evaluate GTAA managers on a qualitative basis as well as a quantitative basis. Understanding the process whereby a manager determines relative value among asset classes is helpful. Some managers rely purely on quantitative models, others use fundamental measures, and some use a combination of both methods. Investors should also examine the risk controls in the investment process. Firms need to have the internal capabilities necessary to implement a global strategy, such as high-quality risk monitoring systems and vendor data, as well as an investment team with talent and skill in global investing and quantitative modeling. In general, most GTAA funds are offered by large investment organizations that have stringent risk controls in place.

CONCLUSION

Investors hoping to reap the benefits of risk reduction, uncorrelated returns, and liquidity from GTAA strategies need to be clear on what gap they are trying to fill in their portfolios and should understand that GTAA strategies are not readily comparable with each other. Standard benchmarks such as peer groups and passive indices may not fully capture the risk/return profile of the strategy being evaluated. Investors should also have realistic expectations for the strategy. GTAA strategies are not designed to outpace equities in bull markets, although they should provide favorable risk-adjusted returns in less frothy or bear markets.

Perhaps the greatest challenge when adopting a GTAA strategy may be the investor’s mindset, according to Arnott. “GTAA strategies can be inherently uncomfortable,” he says. “The temptation for investors is to chase whatever has worked best lately. Getting the customer mindset aligned with a strategy that buys in the face of disappointment is probably the most difficult challenge for any GTAA investor.”

As an example, Arnott cites the spring and summer of 2013 when emerging market stocks cratered. “How many investors viewed that event as painful and got out and how many viewed it as though these are interesting bargains, maybe I should buy?” he asks. “And yet, if people train themselves to think that way and act that way, they will be more successful investors. It does mean subjecting yourself to pain.”

REFERENCES


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