Funds and Advisory

Global tactical asset allocation

An investment strategy for the information age

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Market crises have been occurring with more frequency and severity since the mid-1990s. Unfortunately, some assets that are uncorrelated in bull markets have become highly correlated in bear markets.

There is a growing consensus in the investment community that the next decade will continue to see very high volatility, low growth and possibly inflation in developed economies. Nouriel Roubini views these developments as a 'Ring of fire', PIMCO's Bill Gross believes this state of affairs is the 'New normal,' and the Bank of England Governor Mervyn King has opined that: "The next decade will not be NICE (Non-Inflationary Consistently Expansionary). The next decade is likely to be a 'SOBER' decade – a decade of Savings, Orderly Budgets and Equitable Rebalancing..."

This paper argues that Global Tactical Asset Allocation (GTAA) is a strategy which is well tailored to this new paradigm, generating excess returns with low volatility in both bull and bear markets. It describes how GTAA managers are able to produce these excess returns and how investors can gain access to this growing investment style.

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The views expressed in this article are purely and exclusively those of the authors.

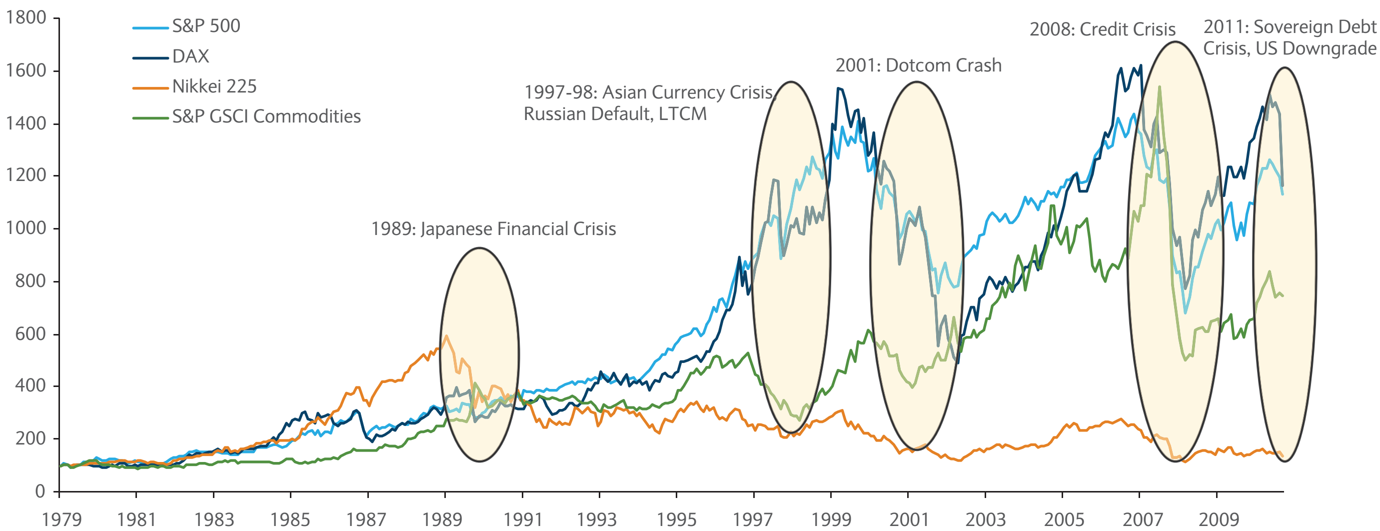
Introduction

Over the past 15 years, we have seen an increase in the frequency and severity of financial crises, as illustrated by the chart 1, below. This has been driven by closer linkages between financial markets across the world, the changing fortunes of different economies and an explosive growth in trading activity.

Financial markets, traditionally driven by institutional investors, have been increasingly impacted by retail investors. Research [1] has found that electronic trading has rapidly opened up the foreign exchange market to retail investors. In 2010, retail investors accounted for 8-10% of spot FX turnover globally (US$125 – 150 billion per day). As recently as 2007 this number was too small to be tracked by surveys.

Increased information, diverging economies, and this greater participation in financial markets by retail investors have all played their part in increasing the risk and severity of financial crises due to increased numbers of market participants, and consequently reducing the effectiveness of long-term strategic asset allocation.

Chart 1: Market crises are occurring with increasing frequency and severity



Source: Bloomberg, September 2011 Past performance is no indication of future performance

Each financial crisis during the last 25 years has been accompanied by very sharp market declines. These events are extremely hazardous, even for long-term strategic investors. If a portfolio worth $100 million falls by 75% to $25 million, then it needs to subsequently generate 300% in order to make up those losses. A downside risk of this magnitude needs to be managed very carefully.

In order to effectively manage investments in this new era of increased negative events, investors cannot necessarily manage risk solely through traditional asset diversification. This year alone, we have already witnessed a severe breakdown in the traditional, inverse correlations between sovereign bonds and equities in Greece, Spain, Portugal, Italy and Ireland. It is critical that investors consider macro, fundamental and behavioural factors before making investment decisions, and be prepared to change their allocations frequently.

Global Tactical Asset Allocation - An overview

GTAA involves investing tactically across a wide range of asset classes on a global basis. Many GTAA managers generated significant excess returns and successfully skirted most of the market volatility in 2008. According to the Mercer database, the average return for GTAA funds in 2008 was 3%, while the HFRX global hedge fund index sank 23.25%. This was driven by an investment process that involves rigorous fundamental, macro and technical analysis and a strong attention to downside risk.

GTAA attempts to generate returns by taking tactical long or short positions across a diversified range of financial instruments. These include futures, swaps and exchange-traded funds, which can often be traded at low cost in deep, liquid markets. In some cases, the use of futures and swaps also allows managers to leverage a portfolio's exposure without recourse to borrowing. This approach not only allows the manager's investment views to be expressed more efficiently, but also reduces the risk of adverse margin calls.

GTAA strategies

There are three major GTAA strategy styles; risk parity, factor-based and directional.

Risk parity

Risk parity funds seek to balance the allocation of risk across asset classes when building diversified portfolios. This means that lower-risk asset classes (such as global fixed income and inflation-linked government bonds) will generally have higher capital allocations than higher-risk asset classes (such as equities). These strategies often employ high leverage and are susceptible to sudden changes in correlation. Some of the biggest risk parity funds generated negative returns in 2008 and going forward, may suffer if, for example, the United States' credit rating is further downgraded by the rating agencies. This is because risk parity funds largely rely on fixed income products, including US Treasuries, for the low volatility segment of their allocations.

Factor-based

Although factor-based strategies have been blamed for the August 2007 quantitative crash[2], they have made a comeback in recent times. These strategies tend to be market neutral and involve exposure to various risk factors such as currency carry, merger arbitrage and commodities roll yield. Though they are able to generate returns in the long run, they can be susceptible to overcrowding, shorting bans and deleveraging. Additionally, during times of market crisis, risk aversion dominates and factor-based strategies can therefore cease to perform.

Directional

Directional strategies involve taking high-conviction directional positions in markets based on forward-looking views. These strategies are able to generate returns without taking on excessive leverage. Directional funds often employ a well-defined risk management process and require sophisticated market skill. There are currently few of them available in the market. We believe that a directional strategy is the most effective of the three.

Relevance of GTAA

Divergence of economies

In the years leading up to the credit crisis, major developing and developed countries around the world enjoyed a period of uninterrupted growth. Since the start of the crisis, however, their economies have started to diverge. The United States and Europe are dealing with high debt burdens and low growth. Big emerging economies like Brazil, China and India, on the other hand, are faced with high inflation and potentially speculative bubbles. Deflation is still a threat in Japan, whereas Germany, Australia and Canada have become big suppliers to emerging markets, hungry for finished luxury goods and natural resources. These multiple imbalances, globalisation and interdependence have thrown up several interesting investment opportunities. GTAA strategies are well placed to take directional positions on the equity markets, rates and currencies of these economies and we believe they are likely to thrive in this complex environment.

Changing correlations in the information age

The information age has altered investors' relationships with the market. Investor access to up-to-date data has seen explosive growth. According to Econsultancy's 2010 Internet Statistics Compendium, broadband penetration in OECD countries has gone from 0% in 1997 to 24% in 2008. This, combined with financial blogs, data aggregators and 24-hour financial news channels, has forced investors to grapple with an overwhelming amount of information at ever-increasing speeds. The result has been a spike in both momentum and rapidly changing correlations amongst asset classes. For example, during the 2000-2002 market crash the correlation between equities and commodities was close to zero. But during the 2008 crash it went up to 70%. GTAA, which allows managers to move swiftly between asset classes of all stripes, is a natural fit for this new environment and is one of the few strategies that has proven itself able to cope with sudden market sell-offs.

Increased liquidity in global markets

Global markets across all assets are more liquid than ever[3]. Given the increased investor demand for liquidity after the credit crisis, we expect this trend will continue. This large increase in liquidity has lead to a reduction in bid-offer spreads, smaller commission rates, and a reduced market impact when assets are traded. This allows GTAA strategies to rapidly react to market conditions and extract value net of transaction costs.

Availability of diverse asset classes

The explosive growth in the number and value of exchange traded funds has provided investors with the opportunity to take nuanced investment views using liquid and exchange-traded instruments. For example, investors can now exploit the relative mispricing between gold futures and gold-related equities. GTAA strategies, with their diverse investment universe, are well placed to take advantage of this trend and enhance returns for their investors.

Conclusion

Investors are now confronted with different challenges to those faced in the last century. A diverging fate of major economies, a more rapid information flow, the greater impact of retail investors on markets and the ability of investors to exploit mismatches across asset classes has led to more turbulent conditions in the market.

In this new environment, with its high liquidity and lower trading costs, new opportunities have opened up for traditional, tactical investors. These investors benefit from the imbalances among high- and low-growth markets, different currency impacts, and credit markets that now value sovereign debt like corporate bonds.

Given these developments, an overly rigid approach to investment thinking can mean lost opportunities. GTAA, with its broad approach, agile investment process and focus on managing downside risk, is well positioned to replace traditional asset allocation approaches for all pension fund managers.

References
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