A Tactical or Strategic Investment Approach?

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It can, and has, been said that all investing involves some degree of market timing. We are all trying to buy something before it increases in value and sell before it declines. It’s the philosophy behind “buy low, sell high”. It is astonishing that a simple philosophy could generate so much controversy until you consider the words of wisdom of Charles D. Ellis: “the real challenge in portfolio management is not how to increase returns, but how to manage risk.” The thought behind this quote is that our real goal as investors is to increase wealth. This implies protecting past gains, while making new ones. The subject of risk is really what generates controversy. How much risk should we take? Do we bet everything on the next roll of the dice or protect past winnings? Inevitably it depends on your taste for risk and ability to absorb losses.

Risk

The subject of investment risk fills volumes, but in reality it is a personal decision. Investment experts have developed numerous methods to control risk, with diversification – or not putting all of your bets in one place – being the basic risk control. When it comes to diversification, there are two general approaches – tactical asset allocation and strategic asset allocation. For the tactician, diversification means holding a portfolio of stocks diversified by sector. The portfolio tactician accepts market risk, carefully timing investments between various markets to generate additional gains when the conditions are right.

On the other side of the fence are the strategists. These are the investors who are unwilling or unable to fully accept this risk. They need certainty of capital or cash flow and can’t take the chance that declines in a single market will jeopardize their savings. They need to carefully diversify market risk as well and do so by implementing a strategic plan where protecting past gains and capital appreciation are joint priorities.

A Tactical vs. Strategic Approach

So which is the better approach? Both have supporters, but the record is far from clear. Tactical asset allocation, in its simplest form, means timing investment flows between two asset classes - stocks and bonds - in an attempt to anticipate which asset class will outperform over the next period. This provides little protection in the event of an incorrect decision, as it is essentially a “right or wrong” decision. With annualized differentials between Canadian stock returns and Canadian bond returns being as great as 50 per cent, the penalty for guessing wrong is high. More complex tactical models add other asset classes, including US and international stocks, bonds, and cash. This provides more levers to control risk, but complicates the tactical process, as every possible combination of assets has a different risk profile. Assessing which decisions worked and which didn’t can also be a challenge. This game is best played using sophisticated mathematical models and is called global tactical asset allocation. In either case, the success rate of tactical approaches is determined by market conditions, with choppy markets providing more opportunities to trade in and out profitably. Strongly trending markets (either upward or downward), meanwhile, provide little opportunity to add value.
A strategic approach to asset allocation consists of implementing a long-term strategy based on an analysis of historical market relationships and a long term forecast. A target portfolio allocation is established at inception based on investors’ long-term goals, such as capital preservation, income requirements, and liquidity needs, as well as their tolerance for risk. Once the strategic allocation is established, the portfolio is rebalanced periodically to its target to adjust for any relative movements in underlying markets. This approach focuses on the long term with stock picking adding value over market timing.

Different Strategies for Different Investors

Another key difference between the two asset allocation approaches is their view of risk. A tactical approach assumes that investors’ risk tolerance levels change with market conditions. At the same time, a tactical approach can be challenging to implement when combined with active stock picking (pure tactical approaches use index funds). Think of tactical asset allocation, for example, as being like traffic control, directing airplanes to different locations, and think of stock picking as being like piloting the planes. For a single investor, the challenge of doing both simultaneously increases the chance of a crash. A bad tactical decision can overwhelm good stock picking, just as a bad air traffic control decision overrides good piloting. We would therefore suggest that tactical asset allocation may be better suited to less delegative investors who accept the risk of a larger loss in order to achieve potentially higher gains.

A strategic approach, meanwhile, assumes that an investor’s risk tolerance is dictated primarily by non-market factors such as retirement plans, income needs, or capital preservation. It is, therefore, well suited to delegative investors who don’t wish to make frequent investment decisions, and can stick to a long term plan.

The Bottom Line

Both tactical and strategic investing should be the result of a robust investment process where investment decisions reflect a well thought out plan with well documented decisions. Your customized Investment Policy Statement is designed to provide you with the most appropriate asset allocation approach based on your unique objectives and your tolerance for risk. If there have been any recent changes to this information, please contact your advisor as it may require an adjustment to your Investment Policy Statement and asset mix. It’s all about a disciplined investment process.

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