Strategic, Tactical, or a Little of Both?

By John L. Jenkins, AEP, EA, CFP®

Managing money means decisions, decisions. Active or passive? Growth or value? Domestic or global? And in today's transitioning market environment where economists debate whether the recovery will take a V, W, or L shape, another key question has emerged: Strategic or tactical?

Although both of these two approaches to asset allocation have their roots in the Nobel-Prize winning principles of Modern Portfolio Theory (MPT) which sets forth the notion that historical performance of each asset class should be the basis for creating an optimal asset mix that strives to maximize returns and tempers risk, the two apply MPT differently.

If you use a strategic asset allocation, based on an evaluation of your goals, risk tolerance and investment time horizon, you will establish what you view as an ideal initial asset mix of equities, fixed income and cash based on the historical performance of each asset class. Of course, over time as the different asset classes move in and out of favor, posting gains or registering losses, that ideal asset allocation will be pulled out of balance. Accordingly, as a strategic asset allocator, you periodically will sell your portfolio winners and buy losers in order to bring your portfolio back to the ideal asset mix you identified at the outset. In other words, you make no attempt to deviate from your target asset class weights because you believe that a mix represents the optimal combination of risk and reward that is designed to provide a better chance of success.

With a strategic asset allocation, you buy, hold, and rebalance periodically. You don't trade because the market moves up or down, but rather when your personal circumstances change or your asset allocations stray too far from your ideal percentages. Note, however, that while financial experts generally recommend evaluating your portfolios with an eye toward rebalancing once a year, today's volatile markets may create the need to rebalance more often.

Tactical asset allocation also begins with an evaluation of your goals, appetite for risk, and investment horizon, but your initial asset allocation plan is not considered a constant, but a starting point. Using a tactical approach, you'll continue to evaluate macroeconomic and leading indicators for various markets, sectors, and asset classes to identify emerging opportunities. You'll make potentially more frequent asset allocation shifts to capitalize on what you perceive as opportunities to potentially boost your total portfolio return and reduce risk. For example, you might make a move to hedge your portfolio against a declining dollar or inflation, or invest in a sector where you expect strong short-term growth.

Whereas strategic asset allocation seeks to return to a previously set asset mix, tactical asset allocation seeks opportunities to create additional alpha -- a measure of risk adjusted performance that measures risk as a comparison of the return achieved relative to the investment's volatility as measured by beta. That is, tactical asset allocation responds to current economic or market conditions, whereas current conditions don't play a central role in determining a strategic asset allocation. If we equate the asset allocation approaches to automobiles, strategic asset allocation is an automatic and tactical asset allocation is a standard.

Which approach is better? It's probably no surprise that neither strategic nor tactical portfolios are appropriate for all investors and in all markets. At a recent Securities America conference, the presenter of "Navigating Volatile Markets," an executive from Genworth Financial Wealth Management, explored this notion by describing secular bull markets as "sailing markets," where the prevailing economic winds are the prime driver of returns and investors seek to participate in broad-based growth. Obviously, strategic asset allocation might have greater success when the positive winds of a sailing market blow. Conversely, secular bear markets were described as "rowing markets," in which headwinds require considerable work to generate competitive returns and reduce market risk. In that environment, tactical asset allocation could post better returns.

Today's investors clearly face significant challenges. Impacted by 2008's losses and yet encouraged by 2009's broad-based market rebound, investors look ahead anticipating more volatility and a likely period of relatively modest returns. Many no longer expect to reach their goals by following the "sailing" strategies that worked so well in the great bull markets of the 80s and 90s and are integrating elements of a "rowing" strategy that could be more appropriate for this decade's challenging markets. Today's ideal vessel may be, as suggested in the "Navigating Volatile Markets" session, the Greek Man-of-War, where sails were supplemented with banks of paddles to enable oarsmen to maneuver in rough seas or battles.

Our transitioning market presents a great time to review what kind of asset allocation you use. A professional financial advisor can help you gauge whether your asset allocation strategy accurately reflects your temperament, time frame and goals and make necessary adjustments should it be beneficial for you to integrate the two approaches. If you would like to review your asset allocation strategy, please call my office for an appointment.

About John Jenkins and Asset Preservation Strategies, Inc.
John Jenkins is president and founder of San Diego-based Asset Preservation Strategies, Inc., which provides a team of financial professionals collaborating to address all of the elements of successful wealth management. He has conducted numerous financial planning workshops during his career and has been a guest on the PBS show "The Money Makers" and its successor, "The Financial Advisors," as well as the syndicated news magazine show "Heartbeat of the City." Jenkins has also authored and co-authored several financial planning books and publications. He is frequently quoted in the financial press, including Financial Planning News, The San Diego Union-Tribune, the La Jolla Light and the San Diego Business Journal. He has been named for three years in a row as a 5 Star, Best in Client Satisfaction Wealth Manager by San Diego Magazine based on surveys of more than 30,000 clients of wealth mangers and data from more than 4,000 financial service professionals. Learn more at www.asset-preservation.com

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* Genworth Financial Wealth Management / Navigating Volatile Markets presentation