DIVERSIFYING... the debate continues

Diversifying an investment across multiple asset classes is widely accepted as a vital strategy for generating returns at a lower level of risk.

Investment managers and academics alike agree that both strategic asset allocation (SAA) and tactical asset allocation (TAA) have key roles to play in delivering sustainable investment growth and managing risk.

A greater edge?

Since investing is fundamentally about meeting long-term financial objectives, it could be argued that SAA has a greater edge.

It is after all the route map that ensures clients do not stray from the route to their eventual investment destination. The fact that it ties into the thinking of two well-regarded academic theories – the Efficient Market Hypothesis (EMH) and Modern Portfolio Theory (MPT) – helps to supports that view.

However, like most theories, they are best proven over the long-term and do not necessarily hold true over shorter time horizons.

Perfectly rational

The EMH states that asset prices reflect all available information and investors are all perfectly rational, so it is impossible to outperform the market.

However, financial markets are cyclical in nature with bull and bear market phases and anomalies in asset prices which are inconsistent with the idea that prices reflect all available information.

Likewise, the MPT states that it is possible to develop an optimal portfolio allocation which maximises returns for a given level of risk by assuming that risk levels for various asset classes are constant over time.

However, risk levels and the way asset classes move relative to each other are not constant.

Important attraction

That is where the attraction of TAA comes in. If SAA is the roadmap that keeps investors on track, then TAA is the tool 'GPS' investment managers and financial advisers use to refresh data and keep their clients' route map updated.

This enables them to respond swiftly to unanticipated obstacles that may occur along the journey.

While SAA is focused on carefully crafting a multi-asset allocation for a long-term horizon, TAA's primary objective is about off-setting the inevitable bumps in the road with a focus on the shorter-term allocation of funds across asset classes.

Controversial belief

Much of the controversy around tactical asset allocation is based on the belief that it relies on speculative market timing.

A counter-argument to that belief is that valuation-based approaches can be used to determine true asset values. This creates the opportunity to take advantage of temporary market inefficiencies.

TAA can be a deliberate and well considered deviation from SAA and can take time to yield results in the form of return enhancement and/or risk mitigation.

The key benefit of SAA is that it maintains broad diversification across asset classes and allows for better risk-adjusted return over full market cycles. TAA, on the other hand, makes it possible to expand the investment universe by tactically investing in asset classes that might not form part of the SAA but represent enticing short-term investment opportunities.

This makes the two approaches complementary rather than opposing. Yet, while each enhances the other, the dilemma about which one leads the way to the investment destination remains.

Strategic role player

What is clearer, however, is that at the end of a client's financial journey, both SAA and TAA can play significant roles in influencing the investment outcome.

While SAA is the cornerstone of the financial advisers' solution to their clients, TAA is dependent on their value proposition. This lies in the extent to which they choose to be actively involved in implementing TAA; there is a spectrum of options ranging from outsourcing the underlying investment activity through the use of balanced funds to maintaining full control of the value chain by utilizing specialist funds.

There is some middle ground too, in which financial advisers may choose to retain some level of control in order to make ad hoc adjustments to protect their clients' capital in times of need.

Ashveena Teeluckdharry-Khusial
Chief Investment Officer
Hollard Investments