Cerulli Survey Results: Advisor Use of Tactical Allocation

By Tyler Cloherty
April 26, 2011

Advisor Perspectives welcomes guest contributions. The views presented here do not necessarily represent those of Advisor Perspectives.

After suffering through the market crisis of 2008-2009, investors are demanding more out of their advisors. They seek downside protection in volatile markets but don't want to sacrifice potential upside returns. Advisors have increasingly turned to tactical allocation to manage client risk. While there has been abundant discussion on how this approach should be executed in theory, we set out to determine what advisors are doing today in their practices.

Advisors burned by market volatility have chosen to supplement their strategic allocation with intermediate defections from long-term portfolio weightings. Despite persuasive academic research admonishing against market timing, advisors believe that they can identify market inflection points, navigate clients away from risk, and reallocate toward asset classes with better risk-adjusted return characteristics. This approach is based on the assumption that advisors can reliably identify which asset classes will outperform in coming periods, which is a dicey proposition at best.

Increasingly commoditized strategic asset allocation technology has also driven the shift to tactical strategies. Companies like MarketRiders provide allocation advice for as little as $10 per month. In response, some advisors are seeking to differentiate themselves by using their market knowledge and access to third-party research and to fund managers to actively monitor and run clients' portfolios.

The question then becomes: Is tactical allocation being used to create more efficient portfolios or as a tool for sales and client retention? Our survey of Advisor Perspectives' readers, conduced in March, provided some key insights.

Exhibit 1
Advisor Portfolio Construction Method Employed, 2011
Source: Cerulli Associates, the Investment Management Consultants Association, and Advisor Perspectives.
Analyst Notes: Other methods included LDI, mean variance, value investing, and insured living benefits.

Method	B/D Advisors	RIAs	All Advisors
Strategic allocation with a tactical overlay	52%	29%	48%

Strategic allocation	13%	20%	14%
Style box	13%	2%	11%
Other	4%	22%	8%
Tactical allocation	4%	12%	6%
Mean variance optimization	4%	10%	5%
Liability-driven investing or asset-liability management	4%	2%	4%
Risk budgeting	4%	2%	4%

In Cerulli's survey results, advisors cited using tactical allocation in one of two primary forms: some practiced unconstrained tactical allocation, while others began with a strategic allocation and supplemented it with a tactical overlay. Strategic allocation with a tactical overlay was the most frequently reported method among both broker-dealer (B/D) advisors (52%) and RIAs (29%). For these advisors, mean-variance optimization was the preferred method to establish the baseline portfolio allocations, basing decisions on historical risk and return profiles for each asset class.

The more frequent use of a constrained tactical allocation is understandable, given that B/Ds require greater homogeneity to withstand compliance oversight. Many B/Ds dictate maximum deviations from strategic allocations for each risk profile, which are continuously monitored and communicated to the home office.

When examining tactical models, a critical question is to what extent the advisor has flexibility to deviate from the long-run allocation. The average deviation among advisors implementing a tactical approach was 21%, but shifts from 2% to 100% were reported. Obviously, movements of this magnitude will generate a wide dispersion of outcomes, with large tracking errors relative to the strategic portfolio. While the assumption of tracking error creates opportunities to outperform benchmarks, the advisor and firm also risk underperforming the benchmark by a wide margin. Unfortunately, for a B/D home office analyzing the strategies used in client portfolios, whether the advisor creates or destroys portfolio value is only known in hindsight.

Exhibit 2
Maximum Percentage Allocated to Tactical Opportunities, 2011
Source: Cerulli Associates, the Investment Management Consultants Association, and Advisor Perspectives.

Tactical Range	B/D Advisors	RIAs	All Advisors
N/A	26.1%	33.3%	27.4%
1-10%	30.4%	12.8%	27.2%
11-15%	13.0%	15.4%	13.5%
16-25%	21.7%	28.2%	22.9%
26%-50%	4.3%	7.7%	5.0%

>50%	4.3%	2.6%	4.0%

Advisors with access to firm-managed account models often have the option of choosing a tactically allocated portfolio from the firm's discretionary platform. These portfolios rely on analysis from the home office investment strategists to manage the direction and size of tactical movements. According to a wirehouse executive, of the 16 models offered at his firm, half are tactical and half are strategic, and 80% of advisors use the tactical options. Those advisors benefit from a process-oriented approach with dedicated professional support, but they sacrifice individual control and usually incur additional cost in comparison to a model where they control their own tactical decisions.

When implementing their own tactical portfolios, 35% of advisors affiliated with B/Ds looked to the advice of their home office research team. In contrast, 27% of RIA advisors reported that they need no assistance to capitalize on tactical opportunities. Recognizing demand, B/D home-office investment management groups, and in some cases RIA custodians, have increased their research offerings to support tactical portfolios by identifying investment opportunities they expect to last between six and 18 months.

Exhibit 3
Primary Source of Assistance for Tactical Opportunities, 2011
Source: Cerulli Associates, the Investment Management Consultants Association, and Advisor Perspectives.
Analyst Note: Other sources included personal research, and paid subscription services.

Source of Assistance	**B/D Advisors**	**RIAs**	**All Advisors**
"Home Office" Research Team	35%	10%	30%
NA, I don't need assitance on this topic	14%	27%	16%
Newsletters / Periodicals	13%	14%	13%
Third-party software / due dilligence	11%	18%	13%
Academic or Think Tank Research	9%	8%	9%
Asset Manager	8%	4%	7%
B/D Home Office Specialist	5%	2%	4%
Other	2%	8%	3%
CIO Outsourcer	2%	4%	3%
Fellow advisors	1%	6%	2%

For those advisors who lack the confidence or support to implement tactical strategies themselves, product providers are doing their best to capitalize on widespread interest. Though few have a track record of success, asset managers are flooding the markets with tactically focused products and supporting market commentary. While advisors may not be comfortable using products like "go anywhere" or absolute return funds as the core of an investor's portfolio, many can be convinced that the products are useful complements to a core strategic allocation.

Likewise, third-party managed account providers such as Curian, Brinker, SEI, and others have met advisor demand for tactical overlay strategies with more diversification. Similar to wirehouse advisors using firm models, however, cost and degree of control remain advisor concerns with outsourced solutions.

Despite instances of firms describing process-oriented approaches, a number of advisors and firms said that a tactical approach was more of an art than a science. While the worry is that advisors are using tactical allocation to chase hot performance, a well-defined, process-oriented strategy can serve the purpose of allaying both client and compliance concerns.

Given the economic uncertainty still facing world markets, Cerulli expects advisor interest in tactical opportunities to continue to grow, but advisors must temper this growth with recognition of their own capabilities and those of their product providers.

Tyler Cloherty is an analyst with Cerulli Associates