



## Letters to the Editor

January 18, 2011

*The following are in response to Nancy Opiela's article, [Tactical Asset Allocation and Market Timing: What's the Difference?](#), which appeared last week:*

Dear Editor,

Thank you for the article.

Market timers seek their return from active management by outguessing the next price move without regard to the economic business fundamentals of the underlying asset being traded; whereas the asset allocator is seeking a substantial portion, if not all, of their return from the economic activity of the underlying assets. Tactical asset allocation may or may not involve market timing, depending upon the reasoning behind the trading decisions.

The difficulty coming to a common definition of market timing is twofold: 1) there is a stigma attached to the term "market timing," both because it connotes speculative day trading and due to its connection to the mutual fund trading scandal (involving Putnam, et al.); 2) the people being asked to define market timing often have not done it.

Like many things, it is not so much what done does, but why one does it.

Regards,

Jeff Cheesman, Managing Director  
Westwood Capital Partners LLC  
Indianapolis, IN

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Dear Editor,

I enjoyed reading Nancy Opiela's article addressing the perceived difference between market timing and tactical asset allocation. As a founding executive of Rydex Investments, we took it upon ourselves to formalize and distinguish a number of different asset allocation approaches. This was a necessary exercise which led to the success of product development, positioning and servicing.

At a high level, we created two camps 1) strategic asset allocation (SAA) and 2) dynamic asset allocation (DAA). With SAA, the customer's investment profile, including risk tolerance, income requirements, etc. determines the look and feel of the portfolio. SAA, also known in some circles as "set it and forget it," includes moderate rebalancing, usually based on a calendar and not an event.



On the other side of the spectrum you have DAA, which allows the market and its movements to determine the look, feel and activity of customers' portfolios. Taking DAA to a more granular definition, there are three very distinct disciplines 1. Market Timing, which is a 100% movement from a single asset class to cash and back within any time frame; 2. Tactical Asset Allocation (TAA), which is the allocation of capital in multiple percentages between multiple asset classes within any time frame; and 3. Sector Rotation, or actively allocating among numerous industry groups following the domestic/global business cycle.

While these definitions are broad in context, they serve as a very useful communication tool at all levels within the investment community.

Robert M. Steele  
President  
Bishop Asset Management  
Boston, MA

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Dear Editor,

I am responding to Nancy Opiela's thought provoking question about "tactical asset allocation" and "market timing." As other commentators have noted, these concepts often are confused in the investing community and public. After setting an appropriate asset mix, the most critical investment policy issue is whether or how one will respond to market fluctuations.

Market timing is a form of tactical asset allocation (TAA), but the two are not synonymous and many people make the mistake of using the terms interchangeably. TAA simply refers to making interim changes to the strategic (long-term) target asset mix in an effort to profit or protect from price fluctuations.

In his book, *The Intelligent Investor*, Benjamin Graham points out two ways to do this – "the way of *timing*, or the way of *pricing*."

A tactical switch is market timing if the decision is based on a market or economic forecast, or some formula or effort to determine which asset classes, sectors or stocks will "in matter of price do better than the rest over a relatively short period." Graham assiduously rejected market timing in his own portfolio policy for practical and theoretical reasons, and he explains them at length in the chapter, *The Investor and Market Fluctuations*.

Timing strategies usually have one of two problems. Most boil down to a process where you would be buying assets after prices have risen, or selling after prices have fallen – just the opposite of what a sensible business person would do. Other timing strategies are



driven by formulas that might work for awhile -- until they fall victim to “Graham’s Law” -- once a system gains enough adherents, it stops working.

(Ironically, that’s what happened to “asset allocation” in the sense that it became a universally popular investment style closely related to ownership of certain asset classes thought to provide diversification, e.g. REITS, commodities, timber, hedge funds, foreign stocks, small cap and value stocks, etc. The system worked well in the tech-led bear market of 2000-03, but then suffered from its own popularity during the recent financial crisis as the diversification effect of these assets was diminished.)

Graham thought investors could be successful by varying the asset mix “according as the level of stock [or other asset] prices is more or less attractive by value standards.” Every business or asset has a certain intrinsic or fair value that is independent of its market price, which may or may not be consistent with fair value. Future return is dependent on the operations of the business and the *price paid*. The risk involved in a particular company is distinct from the risk that an investor might have to sell it at the wrong time or, even more likely, might pay a price far in excess of fair value.

An investor should focus first on a realistic assessment of “staying power” and invest in risky assets only to the extent that one can afford and tolerate the risk. Second he should focus on pricing. The higher the price paid the more that investment results will be divorced from business fundamentals, and the more that “the investor gives precious hostages to fortune, for he must depend on the market itself to validate his commitments.” The lower the price paid for a diversified portfolio, the higher the likely return over the long run. Investors should be patient and try to buy investments at low enough prices so as to offer protection – a margin of safety – against unsatisfactory future developments.

“Buy and Hold” is often misunderstood by proponents and mischaracterized by detractors. It does not mean buy and hold at any price. It means buy and be patient, but by all means be shrewd.

A couple of months ago, my firm made a decision to reduce exposure to intermediate-term government bonds. The decision was based on pricing and prospective returns, not on any market forecast -- no delusions here about forecasting interest rates. Economic signals are misleading at least as often as not. As Yale professor Robert Shiller says, the global economy is very complex and we must resist the temptation to oversimplify. Even when we can see precipitating economic events, predicting market effects is improbable because the precipitating events and their market effects usually are not well lined up. Moreover, peoples’ reactions to the market event, and to one another, create complex market dynamics that are impossible to predict consistently. Case in point – look what happened to bond prices after the Fed began buying bonds under QE2 in the last quarter.



At 2.45%, 10-year Treasury bonds offered a real return of just 0.7%, compared to the long-term real rate-of-return for the asset class at 2.3%. On the other hand, on a normalized basis, the US stock market is priced to provide a real return of about 5.7% over the next ten years, just slightly below the long run average of about 6.5%. This counts to a 50% margin of safety compared to the real bond yield -- a healthy moat in case the future is less than hoped. (For perspective, the stock market had a negative margin of safety in 2001.)

We also note that today (in mid January) many high quality, dividend paying stocks have lagged the market advance and are available at attractive prices. Abbott Labs, Chevron, Johnson & Johnson, Telefonica, JP Morgan and Intel are good examples, each providing an earnings yield of 9% to 11% compared with the 3.3% 10-year bond yield -- margins of safety ranging from 57% to 77%.

We have no idea whether the stock market will go up or down this year, but the risk-return proposition in companies like Microsoft is compelling. Ten years ago MSFT offered an earnings yield of just 2.2% while the 10-year bond yield was 5.2%. The stock is offered at about the same price today, though net income tripled and earnings per share quadrupled. At the current price the earnings yield is 8.8% versus the 3.3% bond yield. It wasn't a "Lost Decade" for Microsoft's business, only for the investors who paid too much for the stock during the tech bubble.

Microsoft Margin of Safety (data compliments of Morningstar):

	<a href="#">2001</a>	<a href="#">2002</a>	<a href="#">2003</a>	<a href="#">2004</a>	<a href="#">2005</a>	<a href="#">2006</a>	<a href="#">2007</a>	<a href="#">2008</a>	<a href="#">2009</a>	<a href="#">2010</a>
Revenue \$B	25,296	28,365	32,187	36,835	39,788	44,282	51,122	60,420	58,437	65,759
Net Income	7,346	7,829	9,993	8,168	12,254	12,599	14,065	17,681	14,569	21,239
EPS	0.66	0.71	0.92	0.75	1.12	1.2	1.42	1.87	1.62	2.45
Dividends			0.08	0.16	0.32	0.34	0.39	0.43	0.5	0.6
Price	\$30	\$34	\$26.79	\$27.58	\$26.75	\$26.15	\$29.86	\$35.19	\$19.53	\$27.91
PE	45.45	47.89	29.12	36.77	23.88	21.79	21.03	18.82	12.06	11.39
Earnings Yield	<b>2.2%</b>	2.1%	3.4%	2.7%	4.2%	4.6%	4.8%	5.3%	8.3%	<b>8.8%</b>
Bond Yield	<u>5.2%</u>									<u>3.3%</u>
Margin of Safety	<b>-30%</b>									<b>55%</b>

It makes no matter if the decision to switch some money from bonds to stocks improves relative performance this year or next. If an investor compares performance to some index over the short term, he is perversely giving up what Graham called a "Basic Advantage" over the Wall Street crowd which has no choice but to react to the markets' every erratic move.



It is instructive that Graham favored a mechanical method for varying his bond and stock mix “for reasons of human nature.” Are advisors now gravitating toward market timing “for reasons of human nature?” It may be more comforting to clients when their advisors appear to have a crystal ball, but perhaps our clients’ interests and ultimately our own are best served by an acceptance that we don’t have a crystal ball and that pretending otherwise can lead to over confidence and bad decisions.

Whatever the strategy you adopt, it should be based on a disciplined intellectual framework for making future decisions and avoiding pitfalls. One of those pitfalls is switching between investment styles based on the emotions of the moment. The human mind can rationalize anything under conditions of uncertainty and Wall Street -- the ultimate “shape shifter” – is only too happy to exploit fear and greed with plausible sounding strategies that, invariably, have been adapted to a statistical record of the past. In my thirty years of experience, and longer study of market history, it seems that investors have been encouraged to trade when they should have been buying and holding, and told to buy and hold when they should have been shrewder.

Best Regards,

Bruce P. Thompson  
President  
Thompson Wealth Management, Ltd.  
Concord, MA

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Dear Editor:

Market timers have taken advantage of international and global arbitrage opportunities, the evolution of technology (such as mutual fund supermarkets) and regulators asleep at the switch, . This led to alpha-producing opportunities through the rapid trading of mutual funds. The original legal construction of a mutual fund was never designed to accommodate rapid trading through supermarket platforms.

This inevitably blew up and the market timing scandal became fully apparent to everyone who did not understand mutual funds. Market timers used to belong to a group called SAAFTI – the Society of Asset Allocators & Fund Timers Incorporated. They would have annual meetings in which they would discuss which fund families had lax screens against fund timers, methods to get around automated checks and screens, which platform did not police timers and a whole host of other issues regarding the implementation of marketing timing.

They changed their name to NAIM – the National Association of Active Investment Managers. Where did the timers go? Many are still spending a lot of time trying to outsmart fund companies and take advantage of new fund companies who do not remember the



timing scandals. Many have set up shop on supermarket platforms which do not stop frequent trading. Fortunately, ETF's came to the rescue for mutual fund companies. Most of the fund timers jumped on the ETF bandwagon because they could trade them all day long.

Unfortunately, many timers found out that producing alpha and outperformance for clients with ETFs was a lot harder than with mutual funds, because ETFs are not disadvantaged by the issues highlighted in the preceding paragraph. Timers quickly found out that clients don't like ticket/transaction charges and the effect of a bid/ask spread on net performance.

Fortunately, many of the problematic timers are using ETFs and I suspect those with skill have a thriving business and those without are no longer in business.

How does this impact the market timer versus tactical asset allocator distinction? The tactical asset allocators who used to be timers are effectively using ETFs to trade around traditional mutual funds. The distinction between timers and tactical asset allocators is very difficult to determine.

I use the following metric: If you tactically move more than 50% of a portfolio's assets with at least 200% turnover, then you are timing the market. If you are moving 25% of the portfolio less than 100% of the time, then you are tactically allocating. The math is simple to understand; no single asset class becomes overvalued or undervalued in less than 12 months. You may invest in the 11<sup>th</sup> month of the cycle, which means you would need to tactically reallocate in 30 days after purchase, but in general it takes asset classes at least 12 months to warrant a 100% change in allocation. I make exceptions for sub-industry ETF's which can make explosive moves, as can ETFs which are tied to very short-term performance moves like the VIX and levered ETFs. If an advisor is managing these investments in a separate pool within a portfolio allocation strategy, this is no different from a portfolio manager of a mutual fund trading underlying stock positions. These sub-portfolios act like an opportunistic basket in a strategy and not an asset allocation strategy for the entire portfolio.

Tactical asset allocators must closely work with fund companies in order to best match their strategy to the underlying vehicle. If the manager is making adjustments to greater than 25% of the portfolio and the changes are greater than 100%, then a typical mutual fund may be impaired by this level of trading. Using a 100% ETF or index mutual fund strategy is probably a better solution.

I suspect in the future, many financial advisors may turn to a new breed of mutual fund which will employ tactical overlays. This will allow financial advisors to set a strategic allocation with the tactical shifts being made at the fund level at much lower cost and with little impact to the integrity of the fund and avoid the harmful side effects of marketing timing like realized capital gains to existing shareholders.



Best Regards,

Pete Moran  
Managing Partner  
DundeeWealth US, LP  
Berwyn, PA

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*The following is in response to Michael Lewitt's article, [The Wages of Growth](#), which appeared last week:*

Dear Editor,

I have a deep concern with Mr. Lewitt's thesis for his article. He makes the point in his opening paragraph that "The world remains a deeply troubled place..."

While this comment made me chuckle, it incensed me as well. Perhaps Mr. Lewitt can tell us at what point in history the world was not a deeply troubled place? Wars, famines, earthquakes and catastrophes of all kinds have always been with us. It is the innate creativity of man that propels humanity forward. Revolutions, recessions, depressions and periods of prosperity follow one another as surely as the spring follows winter. Cities are rebuilt, currencies rise and fall, all the while in the background countless advances in technology, medicine and nearly every human endeavor occur simultaneously.

Perhaps a jewel has been loosed from the crown of US economic dominance and surely the death of Pat Tillman, which Lewitt references, and the misinformation that followed are all matters of fact. That said, the world has always been a deeply troubled place that moves inexorably forward and humanity is surely better off today than it was 10 or 20 or even a hundred years ago.

Best,

Brian Murphy  
Founder/CEO  
Pathways Financial Partners  
Tucson, Arizona

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