



Reducing Risk through Value-Oriented Tactical Strategies

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Conventional wisdom among investment professionals has been that the best way to reduce portfolio risk is to adopt a diversified long-term strategic asset allocation. That paradigm was challenged – deservedly so – following the 2008 financial crisis. Fortunately, an improved paradigm has emerged: Investors should combine long-term strategic allocations with a value-oriented tactical rebalancing strategy.

I will explain how that approach insulates investors from the severe market declines they faced in 2008, but first let's look at how diversification and periodic rebalancing of portfolios back to their target strategic weights failed so miserably.

Diversification and static rebalancing put to the test

Under a strategic asset allocation strategy, an investment professional works with his or her client to determine the client's investment objectives and risk tolerance. The professional then selects various asset classes and formulates a particular portfolio allocation that likely will produce a long-term return and volatility that matches the client's risk tolerance and specific objectives. In determining the portfolio's asset class mix, the professional selects asset classes with returns that are unlikely to move in conjunction with each other during given market conditions (i.e., they have a low or negative correlation of returns).

This diversification is designed to increase the risk-adjusted returns of the portfolio since portfolio's made up of asset classes with low return correlations have historically produced higher annualized returns with lower volatility compared to similar but less diversified portfolios. Once the portfolio's long-term or "strategic" allocation has been established, the professional implements the allocation by selecting individual investments for each asset class. These investments can be passive in nature (such as mutual funds or exchange traded funds that track market indexes), or they can be active in nature (such as actively managed mutual funds, private money managers and/or hedge funds). In some cases a professional will blend the two by investing in both active and passive investments.

Following the portfolio's implementation, the professional periodically rebalances the portfolio back to its long-term strategic allocation in order to make sure that the portfolio remains consistent with the client's risk tolerance.



This strategy worked well during the long bull market that existed prior to the stock market crash of 2008. However, it failed to live up to its promise of risk reduction during the volatile markets of 2008 and early 2009. In fact, most strategic asset allocation approaches suffered significant losses during this period as a result of temporary but significant breakdowns in their diversification. Asset classes that previously had low correlations of returns suddenly began to move downward together. In fact, virtually all of the major asset classes (i.e., domestic and foreign stocks, commodities and real estate) suffered significant simultaneous declines during a relatively short period of time. The only asset class that did not suffer this fate was government bonds. Accordingly, the lesson of the recent market crisis is clear: strategic asset allocation strategies by themselves are not enough to protect portfolios from substantial losses during capital market dislocations like that which occurred in 2008 and early 2009.

Given this new understanding, what are investors to do? Are strategic asset allocation strategies and portfolio diversification no longer useful? Are there new methods that can be used to reduce portfolio risk, or are investors forever subject to the fickle nature of the markets?

A better approach

Fortunately, there is a solution. Although portfolio diversification and strategic strategies failed to hold up during the market crash of 2008, they continue to remain important factors in determining the long-term risk profile of a portfolio, given that market dislocations like that which occurred in 2008 and early 2009 are not frequent occurrences.

However, there is now an understanding that static portfolio allocations are a poor means of mitigating risk and that portfolio diversification alone is no longer enough. Rather, as advocated by David Darst in *The Little Book that Saves Your Assets – What the Rich Do to Stay Wealthy in Up and Down Markets*, investors should combine a long-term strategic allocation with a value-oriented tactical rebalancing strategy.

Under such a strategy, an investor first formulates his or her long-term strategic asset allocation by employing traditional diversification principles. Once the strategic allocation has been established, each asset class' value is determined and periodic tactical (i.e., quarterly or annual) shifts are made to the portfolio's strategic allocation. These tactical shifts involve increasing portfolio weights for undervalued asset classes and decreasing portfolio weights for overvalued asset classes. Such increases or decreases are typically limited to a maximum percentage (i.e., 20% to 30%) in order to prevent making "all or nothing" bets that would completely abrogate the portfolio's long-term risk profile. The last component of this strategy involves periodically rebalancing the portfolio to its current tactical allocation.

By taking into account current asset class values, a value-oriented tactical strategy has the potential to produce higher long-term returns with lower risk when compared to a strategy



that employs only static rebalancing. The potentially lower risk associated with a value-oriented tactical strategy comes from an investor's ability to limit his or her exposure to overvalued asset classes that are likely to produce negative or below-average long-term returns.

Similarly, the potentially higher returns associated with a value-oriented tactical strategy come from an investor's greater exposure to underpriced asset classes that are likely to produce above-average long-term returns. However, as it may take several months or years for an asset class to return to its fair value, an investment time horizon of at least seven years is generally required for the full benefits of this strategy to be realized. Therefore, this strategy is best suited for long-term investors such as endowments, foundations and individuals who are a decade or more from retirement.

Asset class valuation measures

Until recently, many investors have been reluctant to adopt value-oriented tactical strategies. This reluctance was primarily due to their long-standing belief in the Efficient Market Hypothesis, which holds that capital markets are always accurately priced. However, the market collapse of 2008 (and its subsequent rebound) has caused many to question whether markets are always efficient. These doubts have been further promoted by contemporary research from economists Robert Shiller of Yale, John Campbell of Harvard and Andrew Smithers of Smithers & Co., which has shown that capital market prices tend to fluctuate around a definable measure of long-term fundamental value and are thus predictable over the long-term. This research provides direct evidence that asset classes can be over- or undervalued from time to time. It also demonstrates that reliable measures for determining the degree to which a market or asset class is over- or undervalued do in fact exist.

The two valuation measures for the US stock market espoused by Campbell, Shiller and Smithers are the Cyclically Adjusted Price-to-Earnings Ratio ("CAPE") and the Equity-Q Ratio. The CAPE is calculated by dividing the current inflation-adjusted price of the S&P 500 by the average inflation-adjusted earnings of the last 10 years. The Equity-Q Ratio is a modified version of the Tobin's-Q Ratio, which was first conceptualized by Nobel laureate economist James Tobin in 1969. In its simplest form, it is calculated as the current value of the US stock market divided by the total value of US corporate net worth. To determine the valuation of the market, the current value of each ratio is compared to its long-term average. Thus, if the CAPE or Equity-Q Ratio is substantially above its long-term average, this suggests that the US stock market is substantially overvalued, and vice versa.

Another way to value the US stock market is to compare the market's current inflation-adjusted price to its long-term (i.e., 15- or 20-year) simple moving average inflation-adjusted price. Under this measure, if the inflation-adjusted price of the S&P 500 is substantially above its 15- or 20-year simple moving average, the future return of the S&P 500 is likely to be substantially below its long-term average, and vice versa. The rationale



for this measure is the well established principle that market prices tend to revert to their long-term mean average.

Nor are valuation measures limited to just the US stock market. In their paper [Valuation Ratios and the Long-Run Stock Market Outlook: An Update](#), Campbell and Shiller mention that the CAPE and the traditional Price-to-Book Value Ratio may each be a good means of valuing foreign stock markets. Similarly, research published by professors Kursat Aydogan and Guner Gursoy of Bilkent University suggest that the traditional (i.e., non-inflation adjusted) Price-to-Earnings Ratio and Price-to Book Value Ratio are valid measures for predicting the current value and long-term future returns of foreign emerging stock markets.

With regard to US real estate, research by Green Street Advisors and others has shown that both the Price-to-Net Asset Value Ratio and the difference between the current dividend yield for the US real estate investment trust (REIT) market and the current yield for the 10-year US treasury bond are valid indicators of the current value of the US REIT market. Moreover, the previously mentioned simple moving average inflation-adjusted price measure also can be used to determine the value of markets other than the US stock market, such as foreign stocks, US real estate and commodities.

Although a complete discussion of the valuation measures for each capital market is beyond the scope of this article, the existence of legitimate methods for determining the value of multiple global asset classes makes the application of a value-oriented tactical asset allocation strategy a practical way to limit the level of risk inherent within an investment portfolio. Therefore, given the recent increase in market volatility, investors should adopt such a strategy to protect their portfolios from the next market dislocation.

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