Letter to the Editor – Tactical Asset Allocation v. Behavioral Finance

March 13, 2012

The following is in response to Christopher Sidoni's article, The Conflict between Tactical Asset Allocation and Behavioral Finance, which appeared on February 21:

Dear Editor,

In his recent article, Christopher Sidoni commented on our December 2011 *Journal of Financial Planning* article, Improving Risk Adjusted Returns Using Market-Valuation-Based Tactical Asset Allocation Strategies. Sidoni took issue with our proposed strategy of tactically changing portfolio asset allocation at valuation extremes using a simple rules-based valuation approach.

Sidoni suggested that clients will not allow advisors to take such a contrarian approach at extremes because market valuation is a poor tool for market timing. He argued that valuation-based asset allocation shifts can be "wrong" for long periods of time, leading to a risk that clients may abandon the strategy before they are rewarded. He also suggested that the strategy we proposed in our article does not yield high enough after-tax excess returns to offset the risk of a client revolt at market extremes for advisors who are "early" in making tactical shifts in their portfolio.

Hopefully Sidoni hasn't missed the main points of our article. First, we did not, and do not, advocate that investors blindly use such a simple rules-based approach in managing portfolios if they are unwilling to stay the course. (Investors who are unwilling to stay the course, however, will not likely be happy with *any* equity-based investment strategy as the market goes through its volatile cycles!)

We set out to disprove the notion that market movements are random and that market valuation does not matter to future portfolio returns. Our research showed with a 99% level of statistical confidence that valuation, measured by using five-year normalized price-to-earnings ratios, does predict future stock market returns, as well as both stock- and bond-market standard deviations, over subsequent five-year periods. We then showed how implementing a simple rules-based strategy using market valuation as a method to change asset allocation could earn excess returns and significantly reduce portfolio volatility in down markets.

For many financial advisors who claim that tactical asset allocation, to the extent that it entails "market timing," is purely a game of chance, we hoped the study would further their understanding of how market valuation-based tactical shifts can be more than just a

© Copyright 2012, Advisor Perspectives, Inc. All rights reserved.

guessing game. The evidence that higher returns can be had with less risk, we hoped, might encourage them to look further into the benefits of tactical asset allocation.

Sidoni was correct in his contention that market valuation can be “wrong” for long periods of time, and he correctly pointed out that clients may not be happy and may abandon the strategy of advisors who have made asset allocation shifts based solely on long-term market valuation. Clients may be equally upset, however, with advisors who persist in buying and holding asset classes when they are purchased at overvalued extremes and subsequently earn far less than expected historical average returns for the subsequent five- to 20-year period.

In fact, the peculiar assertion that clients are unlikely to forgive timing errors using tactical asset allocation strategies, but are more likely to forgive long-term underperformance in the form of buying and holding during secular bear markets, many financial advisors across the industry should recognize as highly problematic. Perhaps this is why, as Sidoni observed in his article, Bob Veres showed that 80% of financial advisors in a recent survey expected to make a tactical change to their portfolio in the three months following the survey. Advisors have either concluded that tactical asset allocation is adding value to client portfolios, or they believe that the business risk of buy-and-hold investing – asking clients to do nothing while they steadily fall behind their financial planning goals – outweighs the risk of making market-timing errors when tactically adjusting portfolios.

That this trend has played out in recent years should be no surprise. Two of us, Solow and Kitces, predicted in Understanding Secular Bear Markets: Concerns and Strategies for Financial Planners in the *Journal of Financial Planning* in March 2006 that the extended period of substandard returns since 2000 would lead to the rise of more active management strategies. be they stock selection, sector rotation, or tactical asset allocation. Buy-and-hold simply does not sell during a secular bear market; nor should it.

Our firm, Pinnacle Advisory Group, now uses three methods to find value and control risk. We analyze the business and economic cycle, investors’ behavior (an approach commonly known as “technical analysis”) and traditional market valuation, then we make tactical allocations accordingly. Of the three, traditional valuation is rarely given the highest weight in the decision-making process, both because it can be a poor “market timing” metric on a standalone basis and because we rarely find market valuation to be extreme enough to merit a trade on that basis alone.

Our models for determining market valuation are somewhat complex, and they include many different methods of earnings-based valuation, such as forward operating, trailing normalized five-year, trailing normalized 10-year, price-to-peak and others. We also analyze non-earnings-based measures, like price-to-sales and price-to-book, and intrinsic valuation measures, like Tobin’s Q. While our December 2011 article used normalized five-year P/E multiples to determine valuation extremes, we hope readers did not take our hypothetical simplified rules-based approach as a proposed panacea. We do not ignore

© Copyright 2012, Advisor Perspectives, Inc. All rights reserved.

the subtle realities of making “real time” tactical adjustments to portfolios, especially as a fiduciary manager on behalf of clients, and we would not expect others to do so either.

Pinnacle’s actual investment strategy, more complex than the simplified hypothetical strategy we proposed in our article, makes every effort to avoid large market-timing mistakes. We use both quantitative and qualitative decision-making techniques; we take a team approach to decision-making to avoid relying on the judgment of one “superstar manager;” we measure value using several different methodologies; and, to reduce sensitivity to a timing error in any single large transaction, we make incremental changes to portfolio construction. Advisors should consider all of these as a means to minimize the pitfalls of market-timing errors when making tactical asset allocation shifts, while still harvesting the valuation-based investment opportunities that may arise.

What’s more, we find that the pitfalls of active investing, and the risk of clients abandoning the strategy, are easier to address when expectations are set properly, especially when the alternative is the certainty that an investor will underperform the markets when he or she buys and holds at a valuation extreme. That is particularly true considering the adverse impact such buy-and-hold decisions can have on the viability of a client’s financial plan and their willingness to keep staying the course.

Sidoni concluded his article with the following admonition: “Price matters! Valuation information should feature prominently in setting client expectations and in developing the realistic capital market assumptions upon which financial modeling depends. But advisors should exercise caution in employing tactical asset allocation strategies based on market valuation. As the size of the opportunity grows, so does the pressure to abandon the very strategies that are designed to profit from such an opportunity.”

We couldn’t agree more.

Yours truly,

Kenneth R. Solow
Michael Kitces
Sauro Locatelli
Pinnacle Advisory Group
Columbia, MD

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
http://www.advisorperspectives.com/subscribers/subscribe.php

© Copyright 2012, Advisor Perspectives, Inc. All rights reserved.