The Conflict between Tactical Asset Allocation and Behavioral Finance

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How's this for irony? Certain investor behavior creates the conditions for a tactical asset allocation strategy to succeed – but the same behavior simultaneously Increases the likelihood that clients will not follow the strategy.

Recent research by Ken Solow, Michael Kitces and Sauro Locatelli identified a promising approach to tactical portfolio strategy, but our firm's experience indicates clients will be reluctant to follow this approach –particularly when the expected payoff is highest.

In the January 2012 issue of *Financial Planning*, Bob Veres reported the results of a survey that he and *Advisor Perspectives* conducted regarding tactical asset allocation. Of the more than 1,000 advisors in the sample, he found that more than 80% of them expected to make at least one tactical adjustment to client portfolios in the three months following the survey. His survey results correspond with what seems to be a growing interest in tactical strategies by advisors.

Veres' article came just a month after another that appeared in the December 2011 issue of the *Journal of Financial Planning*. "Improving Risk-Adjusted Returns Using Market-Valuation-Based Tactical Asset Allocation Strategies," by Solow, Kitces and Locatelli, advocated making relatively infrequent tactical asset allocation changes at stock market valuation extremes, a strategy that is interesting for two reasons. First, the strategy and its results can be studied over a very long time and through many different market environments, and, second, the market forces that make this tactical strategy promising seem likely to persist.

The authors' strategy involves a tactical underweight or overweight to equities when the stock market is at unusually high or low valuation levels. Such valuations generally occur when investors are overly optimistic or pessimistic about the future (i.e., euphoric or fearful, respectively). Periods of high valuations, and perhaps excessive optimism, are usually followed by below-average long-term returns. The opposite has also been true – periods of excessive pessimism are usually followed by above-average long-term returns. Their strategy capitalizes on these episodes of extreme investor sentiment and the broad mispricing they create.

Investors have always allowed emotion to sway investment decisions, and it is likely that they always will. The persistence of this market dynamic, however, raises questions about the real-world applicability of any strategy designed to capitalize on it. Any advisor who is considering adopting a market-valuation-based tactical strategy needs to think carefully about its implications.

After all, if extreme stock market valuations occur when the majority of investors are either overly optimistic or pessimistic, how will an advisory firm adopting this strategy convince their clients to run against the crowd? Not all clients will stick with an inherently contrarian strategy, which raises the further question of when clients who abandon the strategy will choose to do so and how that may affect their returns.

For example, the most recent of the rolling 30-year periods that Solow, Kitces and Locatelli studied included the low valuation extreme of the early 1980s and the high valuation extreme of the late 1990s. Investors following their proposed tactical strategy would have received a “sell” signal in early 1996. After dutifully reducing their stock market allocations as the strategy dictates, how many clients would have waited patiently for their tactical move to pay off while the stock market continued its meteoric rise for an additional four years?

It’s important to always keep in mind that, although an advisor may be an important voice influencing a client’s investment behavior, his or hers is not the only voice that client hears. The client is also exposed to the financial media, friends, family, and sometimes other investment professionals, few of whom are likely to be following the prescribed contrarian strategy. When these other centers of influence boast of superior results, particularly over prolonged periods, the pressure on the client to desert the contrarian strategy mounts.

Investors do not abandon a strategy after it has produced above-average results. They do so when they become convinced that “it isn’t working” or that “times have changed.” When investors change course, they are most likely to embrace what has “worked” most recently and, in doing so, commence a performance-chasing cycle that likely will detract from their long-term returns. Many advisors can recall situations in which some of their clients followed a sensible diversified strategy, perhaps for many years, only to abandon it during the market extremes of the late 1990s or the recent financial crisis.

The increased risk of strategy abandonment inherent in a contrarian philosophy is especially problematic for advisors who act as fiduciaries. Imagine an advisor, three-fourths of whose clients are able to follow a contrarian strategy and achieve above-average returns from the strategy over time. One-fourth of the clients ultimately abandon the contrarian strategy and do major harm to their long-term finances. Is this an acceptable state of affairs for fiduciaries, who are tasked with looking after the financial best interests of all of their clients?

Given these concerns, is the tactical strategy worth pursuing?

Probably not. Solow, Kitces and Locatelli found that their tactical portfolios outperformed a "static" allocation (50/50 stocks/bonds) by 0.11% to 0.58% on an after-tax, annually compounded basis, depending on the size of the tactical shift (larger shifts resulted in larger incremental returns). These are relatively meager rewards given the significant risk of strategy abandonment.

The trouble with this tactical strategy centers on the uncertain timing of valuation mean reversion. Historically, periods of either very expensive or inexpensive stock prices have eventually given way to a more typical stock valuation environment. But investors seeking to capitalize on this mean reversion often must suffer through years of continuing market irrationality, watching and waiting as expensive markets move higher or bargain markets continue to decline. We are reminded of Jeremy Grantham's observation that valuations are like gravity – a weak but relentless force.

An important relationship exists between stock market valuations and subsequent long-term returns. 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.

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