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Tactical Asset Allocation: Fine Tuning a Longer Term Strategy

Readers of this column have undoubtedly noticed a fairly conservative slant to my advice, generally favoring a long-term investment strategy, possibly missing some short term opportunities, while avoiding the risk of erroneously forecasting the direction of the market. This article from the Financial Planning Association discusses an approach intended to be more responsive to market conditions.

Strategic asset allocation, the practice of maintaining a strategic mix of stocks, bonds, and cash, has guided many investors in creating portfolios that suit their risk profile and long-term investing goals.1 This widely used strategy is a long-term, relatively static tool and is not intended to take advantage of short-term market opportunities.

Proponents of tactical asset allocation (TAA), in contrast, take a shorter-term view. TAA is the practice of shifting an asset allocation by relatively small amounts (typically 5% or 10%) to capitalize on economic or market conditions that may offer near-term opportunities. TAA differs from rebalancing, which involves periodic adjustments to your strategic allocation as a result of portfolio drift or a change in personal circumstances. With tactical asset allocation, you maintain a strategic allocation target, but fine tune the exact mix based on expectations of what you believe will happen in the financial markets.

Assessing Risk and Return

For example, suppose an investor started with an initial target mix of 60% stocks and 40% bonds on October 1, 2011. Believing that the stock market was undervalued and a recovery was in sight, the investor switched the allocation to 70% stocks and 30% bonds on that date. Between the date of the allocation change and March 23, 2012, the revised 70/30 allocation would have generated a return of 15.1% compared with the 60/40 allocation, which would have returned 13.2%.2

Tactical asset allocation also can work on the downside. For example, suppose a hypothetical investor, sensing trouble in the financial markets in light of the credit crisis, reduced an initial allocation of 60% stocks/40% bonds to 50% stocks/50% bonds on October 1, 2007. Between the date of the allocation change and May 1, 2008, the 50/50 allocation would have generated a return of -1.6%, compared with a return of -2.9% for the original 60/40 mix.2

Within an Asset Class

TAA also can involve shifting allocations within an asset class. For example, an equity portion of a portfolio may be shifted to include more small-cap stocks, more large-cap stocks, or other areas where an investor perceives a short-term opportunity.3 Note that mutual funds that invest in these areas may impose restrictions on short-term trading, and it is important to understand these restrictions before making an investment.

A tactical approach involves making a judgment call on where you think the economy and the financial markets may be headed. Accordingly, a tactical allocation strategy can increase portfolio risk, especially if tactical allocations emphasize riskier asset classes. This is why it may be a good idea to set percentage limits on allocation shifts and time limits on how long you want to keep these shifts in place.

In addition, when evaluating investment gains that are short-term in nature, such as those on investments held for one year or less, it is important to understand taxes on short-term capital gains. Currently, short-term capital gains are taxed as ordinary income, where the highest marginal tax rate is 35%. In contrast, long-term capital gains on investments held for more than one year are taxed at 15%.

Source/Disclaimer:

1Asset allocation does not assure a profit or protect against a loss in a declining market.

2Source: McGraw-Hill Financial Communications. Stocks are represented by the total return of the S&P 500, bonds by the return of the Barclays U.S. Aggregate Bond Index. Investing in stocks involves risk, including loss of principal. Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values are subject to availability and change in price. It is not possible to invest directly in an index. Past performance does not guarantee future results.

3Securities of smaller companies may be more volatile than those of larger companies. The illiquidity of the small-cap market may adversely affect the value of these investments.

This article is provided by the Financial Planning Association, the membership organization for the financial planning community, and is brought to you by Art Stahl, a member of the Greater Hudson Valley chapter of the FPA. Art, a member of the Hudson Valley Marine Trades Association, is an Investment Advisor Representative with Financial Network Investment Corporation, Member SIPC, 500 Glenpointe Centre West, Teaneck, NJ 07666.

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