

Strategic vs. tactical asset allocation - a performance analysis

Abstract

In this paper, we look at European strategic and tactical allocation funds. We examine the strong growth in AuM (Assets under management) that tactical allocation funds in particular have experienced in recent years. We analyze whether the high net inflow – probably rooted in investor expectations of higher returns from the tactical approach – is actually justified by higher performance from these funds.

First, based on Morningstar Direct data, we look at the asset flows and growth rates of allocation funds. We find that while strategic and tactical allocation funds grew AuM at a broadly similar rate between 2007 and 2012, tactical funds have subsequently taken off.

Next, we discuss the characteristics of the two categories, looking at cost ratios, risk etc. We find that – although the tactical funds might utilize a wider range of asset classes, and a more dynamic allocation approach, their average equity exposure and risk profile resembles that of a moderate strategic fund. We also find that the costs of tactical funds are, on average, significantly higher than strategic funds.

Finally, our performance analysis shows that the historical performance (risk/return profile) of tactical funds, measured over longer time periods has, on average, been inferior to strategic funds. Thus, we find that the tremendous growth in tactical funds in recent years does not seem to be justified by higher performance.

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Introduction

In recent years, terms like 'allocation funds', 'blend funds', 'mix funds' and 'mixed products' have become increasingly common in portfolio management. These terms cover funds that invest in one or more asset classes, typically a mix of equities and various types of bonds. The basic idea is that the majority of the fluctuations in a portfolio's return can be explained by the overall allocation of the portfolio - as opposed to the selection of individual securities. The advantage is that investors can, by means of a single product/fund, obtain a very well-diversified portfolio of equities and bonds with allocation into several thousand securities.

Within this range of 'combined asset class' products, there are two distinct types: 'strategic' and 'tactical' allocation funds. The principal difference between the two being their approach to market timing. In strategic funds, timing and market expectations have limited influence on the allocation. Instead, the risk profile of the funds is usually kept constant by having a relatively fixed allocation to equities and bonds. These products are usually categorized as being 'low-', 'medium-' or 'high-risk', whereby higher risk corresponds with a higher allocation to equities. This gives the investor the opportunity to buy into a suitable risk level.

By contrast, tactical funds – despite potentially investing in exactly the same 'building blocks' as strategic funds – deploy a more dynamic asset allocation, with market expectations and timing being pivotal factors. Here, the allocation to equities can be increased if the portfolio manager (or modeling tool) foresees an economic upturn and vice versa for an economic downturn. Thus, where strategic funds rely on the asset allocation - and an inherent 'mean reversion' process - as the primary return drivers, tactical funds aim to create excess return (or minimize risk) by predicting market movements and their likely effect on the prices of the underlying assets.

Supporters of the strategic allocation approach point to the difficulties involved in market timing – both when entering and exiting a tactical shift – as well as the higher trading costs caused by such tactical adjustments. Supporters of the tactical approach point to the advantage of having the flexibility to adjust to different market environments (e.g. the possibility to move into cash in high-risk scenarios). They also claim that transaction costs today play only a minor role due to global financial competition.

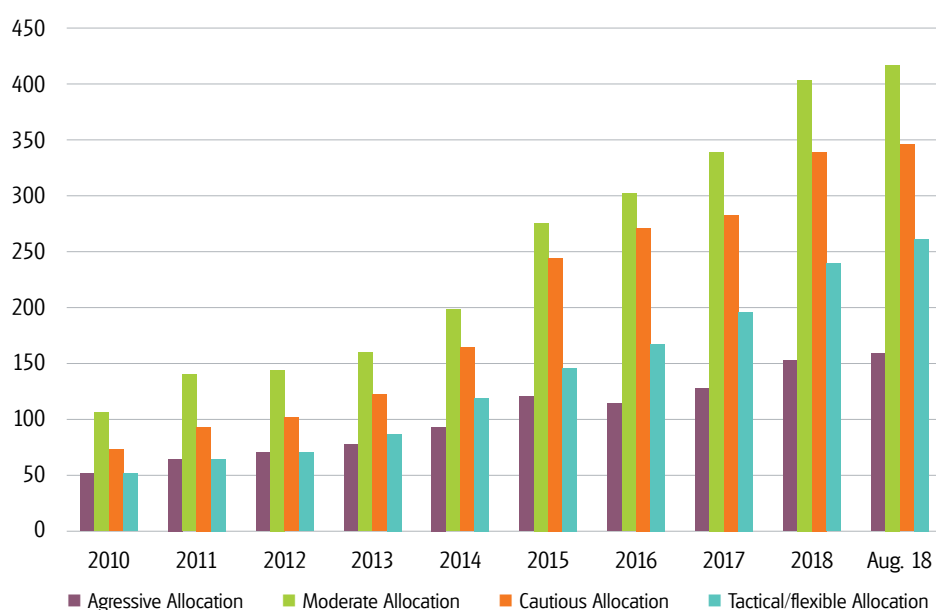
In this paper, we do not address which approach is the better. Instead, we focus on the data and discuss the characteristics and historical performance of allocation funds.

Setting the scene

Exhibit 1 shows the total AuM in European domiciled strategic allocation funds, (categorized by Morningstar Direct as: 'Aggressive', 'Moderate' and 'Cautious' Allocation), alongside tactical allocation funds (categorized by Morningstar Direct as 'Flexible Allocation'). The table shows the tremendous growth in all four types of allocation funds increasing from 280 €bn. in 2010 to approx. 1,200 €bn. in August 2018. In fact, the AuM of the overall allocation category has increased fivefold over the last 10 years, making it the second highest increase out of all global broad Morningstar categories - effectively beating even the equity and fixed income categories. An estimated 70% of this increase in recent years is attributable to net inflow.

Looking at the graph in more detail, it reveals another interesting fact. Whilst the AuM of both strategic and tactical allocation approaches rose at a broadly similar rate between 2007-2012 tactical allocation has subsequently taken off, with almost 80% growth since 2015, compared to only 44% growth for all forms of strategic allocation combined. Is this increased interest from investors due to higher performance from the tactical funds? This is analyzed below.

Exhibit 1. Total AuM of EU domiciled allocation funds (€bn.)*



Source: Morningstar Direct

* Based on Morningstars 'Total Net Assets' datapoint

Methodology and data

The performance analysis below is based on Morningstar Direct data for 5,556 allocation funds domiciled in Europe. To avoid double counting, feeder funds and funds-of-funds have been excluded. Only the oldest share class has been included to avoid multiple share class inclusion.

The allocation segmentation follows the Morningstar Global category-segmentation except that the study treats those 'strategic' funds where the one-year equity allocation has changed by more than 12% as being tactical (this correction has minor impact, but is intended to avoid funds that are in reality tactical being wrongly categorized as strategic). Tactical allocation is further differentiated from the other three categories in that it typically implies having a broader mandate to invest in a range of asset types (and not only equity, fixed income and cash), with rotating positions in the various assets. The resulting grouping of the funds is shown in the table overleaf.

The table shows that the total number of tactical allocation funds now is higher (1,949) but with a lower average fund

size (156 €m), compared to strategic allocation funds. Tactical funds are, on average, also 'newer' (dating from 2010 compared to '07-'09), corresponding with the high rate of new fund launches in recent years.

In terms of costs, the average cost ratio of tactical funds (1.68%) is significantly higher than for strategic funds (based on t-tests). This may be justified on a fund level by a number of factors, including the use of a more diverse asset palette or a more dynamic investment process. But, interestingly, the current average tactical fund risk profile is similar to that of the average 'moderate' allocation fund, with an average current equity allocation of 49% compared to 43% and an average risk rating (KIID SRRI) of 4.1 compared to 4.0. Therefore, from a current risk perspective it is hard to see why the cost of the two segments should differ.

Finally, the last column shows (as is to be expected) that the equity allocation of the tactical funds fluctuates considerably more than is the case for strategic funds.

Allocation	Typical Equity %*	# funds	Av. Fund size (€m)	Total AuM (€bn.)	Av. Inception Year	Av. Costs**	Av. Equity Alloc %	Av. 1Y Eq.% Change (abs)
Aggressive Allocation	70-90	915	190	162	2007	1.55	68	3
Moderate Allocation	50-70	1,417	315	413	2008	1.53	43	3
Cautious Allocation	20-50	1,275	283	341	2009	1.32	21	3
Tactical Allocation	20-80	1,949	156	289	2010	1.68	49	11
Grand Total		5,556	231	1,205	2009	1.53	45	6

* As defined from the Morningstar Global Category

** KIID Ongoing Charges

Source: Morningstar Direct. Note: The average equity allocation % is the average current net equity allocation. The average 1Y Eq % Change (last column) is the average absolute change in the net equity allocation over the last year.

Performance analysis

Exhibit 2 shows the average gross return (GR) on the y-axis of all the funds over the last 3-, 5-, 10- and 15-years respectively plotted against the risk (x-axis), measured by the standard deviation of the gross returns in euro. The number of funds included is lower than the total number of funds in the analysis because fewer funds have long track records.

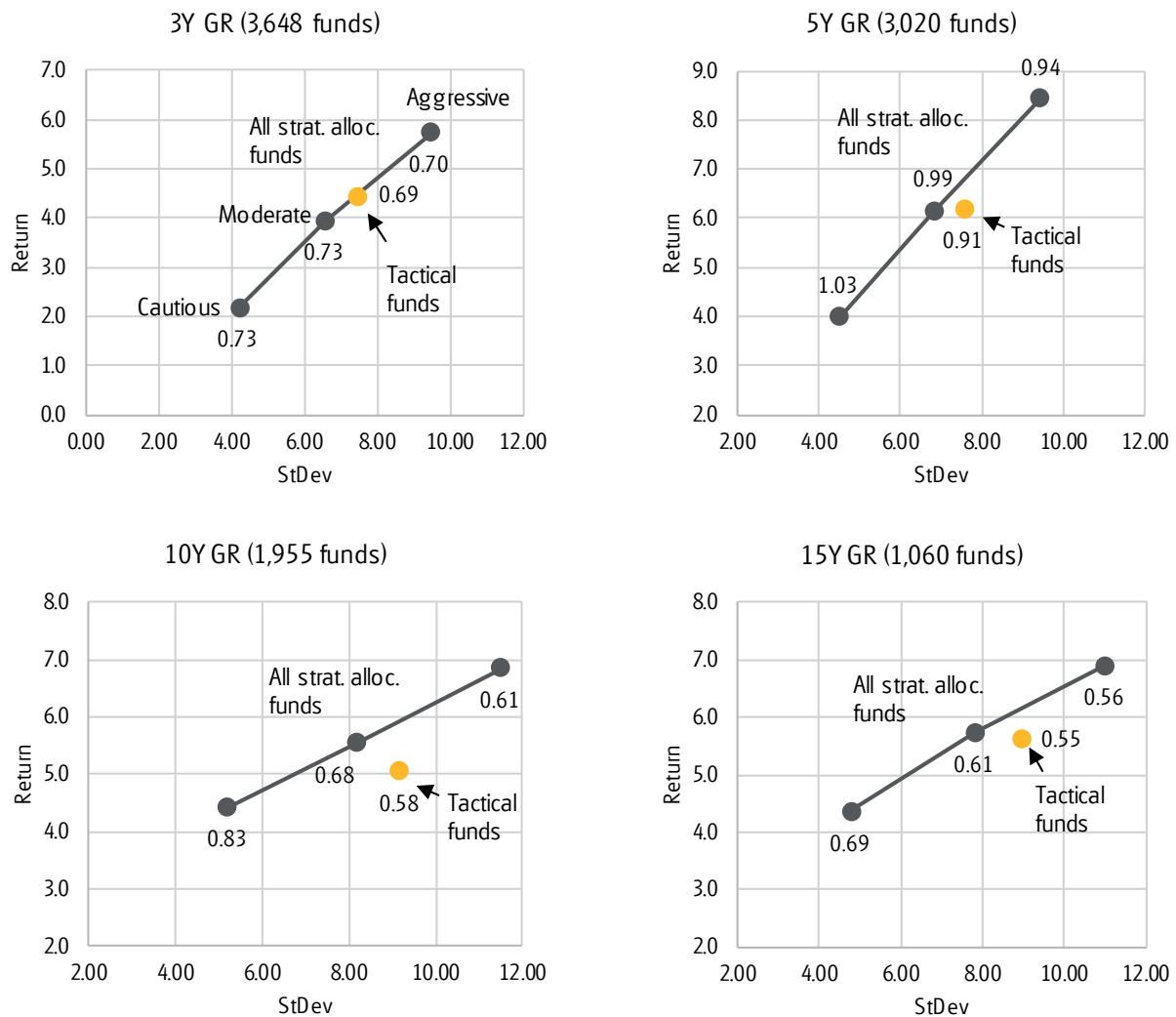
The 3Y graph shows a tie between the average performance of tactical versus strategic allocation funds. However, the 5Y, 10Y and 15Y graphs all show that, while there is a quasi-linear relationship between risk and return of the strategic allocation funds, tactical funds (yellow dot) on average seem to exhibit a higher risk and/or a lower return than that obtainable by a combination of the strategic funds (the dark-plotted line). This corresponds to the yellow dot being below the dark line. Thus, the performance of tactical funds over longer time periods has, on average, been poorer than the strategic funds. Or, put another way, the risk for obtaining a given amount of return has been lower with a combination of strategic funds than with tactical funds. The Sharpe ratios - measuring the excess return over the risk-free rate per unit of risk/volatility, and shown as numbers in the graphs

– confirm this. The same pattern goes for a similar Total Return (after costs) analysis.

The poorer performance of tactical funds over longer time periods is probably linked to large changes in equity allocations after 2008. This will be further discussed in a follow up article to this paper.

As a side note, when looking at strategic funds only, there seems to be a connection between fixed allocations and performance – also linking to what happened after 2008. If we split the strategic funds into two equally-sized pools, based on the steadiness (or otherwise) of their equity allocations over the last 10 years, we see that, while the pools performed equally well over 3 and 5 years, the ‘steady’ pool outperformed the ‘volatile’ one over 10 and 15 years. This is probably attributable to the ‘volatile’ pool having reduced equity allocations in 2008 followed by a slow ‘normalization’ of allocations since then. As equity returns rebounded relatively quickly after 2008, this allocation shift effectively caused the ‘volatile’ funds to ‘miss out’ on this recovery – causing underperformance compared to strategic funds with steadier allocations. Thus, in retrospect, it appears that

Exhibit 2. Average 3-, 5-, 10- and 15-year risk and gross returns in euro (annualized monthly statistics)



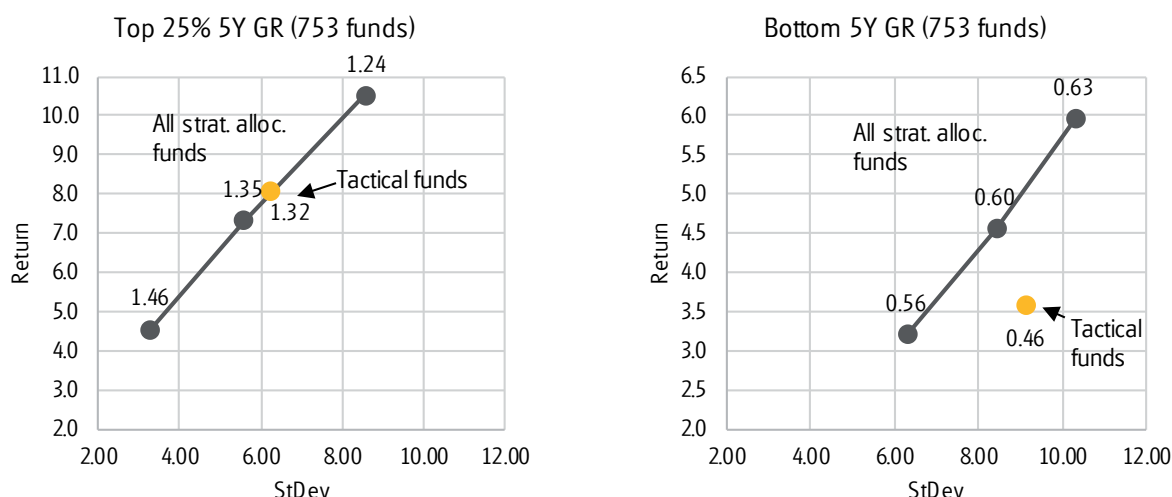
Source: Morningstar Direct and own calculations. The gross return (y-axis) is the annualised Gross Returns in Euro from Morningstar Direct expressed in percentage points and including price changes, returns and dividends but excluding costs. The standard deviation (x-axis) is the Morningstar Direct Standard Deviation calculated on the basis of the monthly Gross Return for the relevant period. The Sharpe ratio is the Morningstar Direct Sharpe Ratio calculated on the basis of the above-mentioned gross return/standard deviation. The risk-free interest is a one-month euro interest. The currency is in euros.

keeping a steady allocation - at least during this period - has been good for performance.

Returning to strategic versus tactical funds, we now look at their relative performance. Have the best-performing tactical funds done better than the best-performing strategic funds? What about the worst-performing funds in each category?

This is examined in Exhibit 3, showing the 5Y Gross Return/risk of the top and bottom 25% performers from each of the four segments. The graphs show that whilst the top quartile of tactical funds seem to have performed in line with the top quartile of strategic funds, the performance gap in the bottom quartile is larger. The same applies to a 3Y or 10Y analysis. This could imply that – on average – it is more

Exhibit 3: Top and bottom 25% (5Y, Gross Return)



Source: Morningstar Direct and own calculations. The gross return (y-axis) is the annualised Gross Returns in Euro from Morningstar Direct expressed in percentage points and including price changes, returns and dividends but excluding costs. The standard deviation (x-axis) is the Morningstar Direct Standard Deviation calculated on the basis of the monthly Gross Return for the relevant period. The Sharpe ratio is the Morningstar Direct Sharpe Ratio calculated on the basis of the above-mentioned gross return/ standard deviation. The risk-free interest is a one-month euro interest. The currency is in euros.

important to pick the right manager for tactical funds than for strategic funds.

Finally, one could ask if the picture is the same when analyzed on an individual country basis. As can be seen from the appendix, this appears to be the case. The only

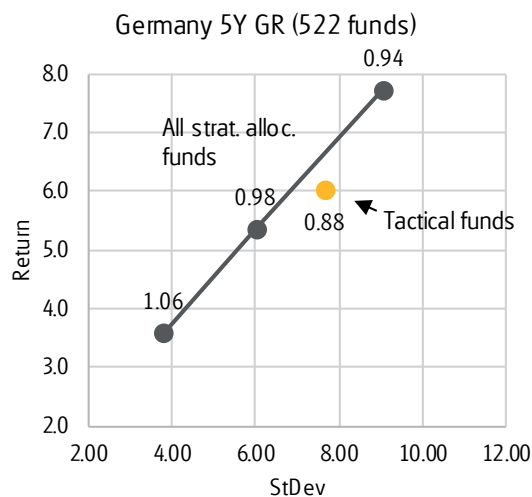
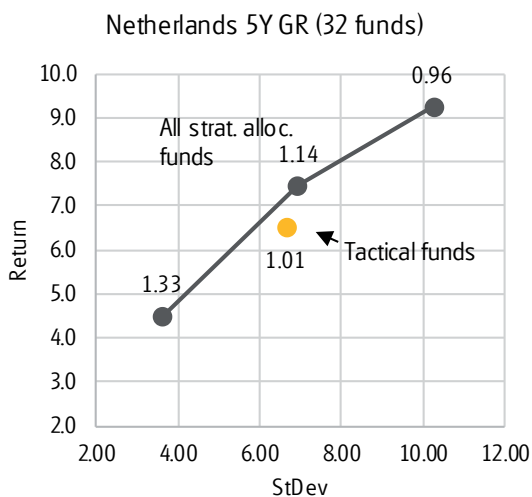
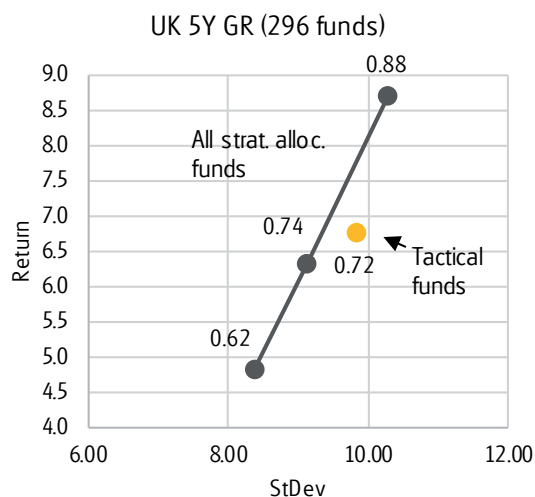
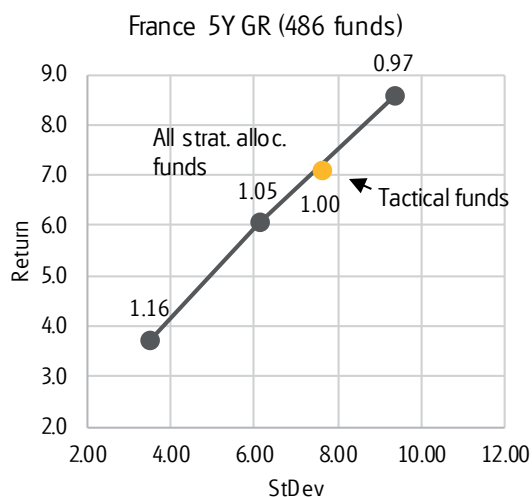
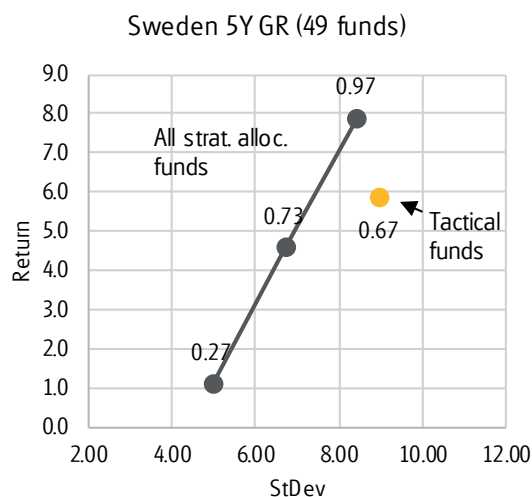
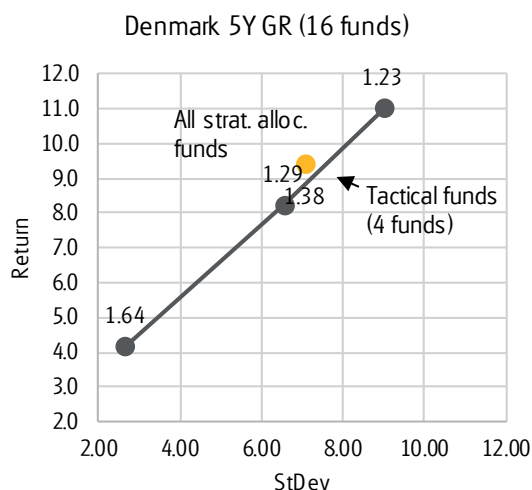
exception is Denmark, where, on average, tactical allocation funds seem to have outperformed strategic allocation funds. But since this sample includes only four tactical funds with a 5-year track record, caution should be applied to conclusions.

Summary

- The number of tactical allocation funds in Europe, as well as their total AuM, has increased sharply in recent years
- While these funds might be more diverse in asset range, and more dynamic in allocation, the current average exposure and risk rating resembles that of an average 'moderate' allocation strategic fund
- The costs of tactical funds are, on average, significantly higher than for strategic funds
- The historical long-term performance (risk/return profile) of the analyzed tactical funds has, on average, been poorer than the corresponding strategic funds
- The difference in performance is smaller for the best-performing funds and bigger for the worst-performing funds – implying that it is more important to pick the right manager for tactical funds than for strategic funds

Please note that this report is one of three insight papers on strategic and tactical allocation funds. If you would like to receive the other two papers by email please sign up at sparinvest.lu/strategic-vs-tactical-asset-allocation

Appendix: Country specific risk/return performance in euro (5Y GR)



Source Morningstar Direct

Note: The country funds are based on the Morningstar Direct "region of sale" data point. If the region of sale is not specifically this country (e.g. if region of sale is European Cross Border or Global Cross Border) the funds are not included. This means that there might be a number of relevant funds for each country, which are not included in the country analysis.