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by Eric J. Weigel

The Performance of Tactical Asset Allocation

Tactical asset allocation (TAA) is the practice of altering asset class exposures in accordance with model-based risk-reward expectations. An analysis of 17 U.S. managers who use TAA to rebalance between large-cap stocks, long-term bonds and cash equivalents reveals that the vast majority provided positive timing ability at a statistically significant level. This holds for both managers' simulated and actual market returns.

The managers' market-timing skills, however, are inversely related to other investment skills. Managers good at timing broad market aggregates appear to be deficient in other investment activities. Transaction costs may partly explain this phenomenon, but the sheer magnitude of the return-diminishing non-market-timing term is too large to be entirely attributable to transaction costs.

Furthermore, the market-timing performances of the managers varied considerably over time. This tendency will probably persist in the future, as managers update their forecasting systems and capital market conditions change.

THE DYNAMIC adjustment of a portfolio's investment weights across broad asset classes has become a hot topic since the October 1987 market crash. Of course, investment managers have been altering exposures to different asset classes according to "gut" feeling or subjective risk/reward assessments for a long time. What is new now is the thorough application of the principles of modern portfolio theory and econometrics to examine quantitatively the expected risk/reward tradeoffs of major asset classes.

A driving force behind the rush to apply quantitative techniques to **dynamic asset allocation** strategies has been recent statistical evidence on the predictability of stock and bond market returns. While most of the analyses have focused on forecastability over long horizons, there is evidence that stock and bond market returns are also predictable (but at more modest levels) over shorter intervals.[1]

From a practical perspective, the result has been the "growth" of money management firms professing to be able to time the movements of broad market aggregates. Their market-timing activities have been labeled "**tactical asset allocation**" (TAA). We estimate that there are currently over $42 billion under management in TAA strategies.

Our study attempts to determine quantitatively the market-timing ability of a sample of 17 U.S. TAA managers. All are major firms managing substantial amounts of money. They all switch funds between large-company stocks, long-term bonds and cash equivalents—a so-called three-way market-timing strategy.

Because of the relatively short history of the strategy, hence the limited number of **market observations**, we formed two samples. One combined manager-simulated with actual market returns. The other used only actual market performance.

The measurement methodology we use is taken from Merton and Henriksson and has its origins in option pricing theory.[2] The **performance attribution** methodology decomposes manager returns into three sources—returns to a static asset class mix, returns to market timing and returns to non-market-timing strategies such as security selection, stock index arbitrage

1. Footnotes appear at end of article.

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