Tactical Asset Allocation: Don't Try This at Home

Making rapid-fire shifts to take advantage of market trends is easier said than done.
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Tactical asset allocation funds typically shift between asset classes in an attempt to benefit from shorter-term changes in market trends. The appeal behind these strategies is obvious: Every once in a while, stories emerge about unusually prescient market calls, such as Elaine Garzarelli's bearish call before Black Monday in October 1987, George Soros' successful bet against the British pound in 1992, and John Paulson's short play on the U.S. housing market in 2006.

Even investors who don't make wholesale changes in their asset allocations are often tempted to be overweight in asset classes that seem promising and shy away from areas that might suffer if certain macroeconomic trends play out. But while shifting an asset mix toward asset classes with better prospects and away from those that might fall out of favor sounds good in theory, this strategy is notoriously difficult to implement in practice.

Indeed, the failure of tactical asset allocation funds suggests investors should not only stay away from funds that follow tactical strategies, but they should also avoid making short-term shifts between asset classes in their own portfolios.

Hard to Love, Harder to Use

Shifting between asset classes hasn't led to a performance edge. In fact, tactical asset allocation funds have fallen behind more static asset allocation funds for every trailing period, as shown in the table below. (I used the allocation -- 50% to 70% equity Morningstar Category for comparison because its risk profile is generally in line with funds in the tactical asset allocation category.) Tactical asset allocation funds have also failed to keep pace with plain-vanilla balanced funds, a subset of the allocation -- 50 to 70% equity category that generally invests in a fairly static mix of about 60% stocks and 40% bonds.

Exhibit 1 Lagging Performance

Category/Group	3 Yr Tot Ret (%)	5 Yr Tot Ret (%)	10 Yr Tot Ret (%)
Tactical Allocation	8.36	8.38	6.18
Allocation--50% to 70% Equity	10.73	10.23	9.21
Balanced funds	10.49	9.89	8.93

Source: Morningstar Direct. Data as of August 31, 2021.

What's more, performance would look even worse if it included results for funds that were merged or liquidated. Tactical asset allocation funds have an unusually high mortality rate: Morningstar's database includes a total of 203 unique funds in this category (not including multiple share classes), but 100 of those no longer exist. Funds with weaker performance often quietly disappear, which has the effect of making results for surviving funds look better. And the differences in performance can be significant. Including results for obsolete funds, annualized returns for the trailing 10-year period would drop to 5.28%, compared with 6.18% for only the funds that remain. Tactical asset allocation funds haven't achieved significantly better downside protection, either.

What's behind these abysmal results? At the risk of oversimplifying things, it's hard to make predictions, especially about the future (a quote that could be attributed to Yogi Berra, Mark Twain, or Niels Bohr, depending on the source.) A couple of examples can help illuminate this. PSI Tactical Growth's FXTAX goal is to achieve long-term returns by avoiding major down markets and reallocating assets in response to market change. Over time, its portfolio has veered from leveraged equity exposure to cash positions as high as 74% of assets. But over the past 10 years, its annualized returns have been just 1.25% per year. Management is at least forthright in explaining some of its recent shortcomings: "In looking at how the Fund responded to the market in 2020, it was easy to see that we were a little late in getting out in the spring (though we did move everything to cash on March 13, 2020, for the bulk of the decline), and we were a little late in getting back in (we re-entered the market on May 19, 2020) when the stimulus/rescue programs were announced."

Similarly, AmericaFirst Monthly Risk-On Risk-Off Fund ABRFX makes rapid changes to its asset allocation in response to market and economic trends. The fund uses eight factors to determine how much to invest in stocks and how much to invest in Treasury bonds. This strategy has resulted in a frenetic turnover rate and dramatic portfolio swings, with stock exposure ranging from a low of 25% of assets to more than 100% of assets over the past 10 years. But this trading activity hasn't led to better results: The fund has lagged a standard balanced portfolio of 60% stocks and 40% bonds (rebalanced annually) by more than 7 percentage points per year over the past 10 years.

High costs have also weighed down results for tactical asset allocation funds. On average, funds in this category levy annual expense ratios of 1.55% of assets, making them one of the pricier categories in Morningstar's database. Because fund expenses come directly out of returns, high costs are a contributing factor behind their disappointing returns.

Poor returns and high costs have made tactical asset allocation funds difficult to use effectively in a portfolio. After accounting for the timing of cash inflows and outflows, investor returns (also known as dollar-weighted returns or internal rates of return) have been even lower than reported total returns. Over the 10-year period ended Dec. 31, 2020, investor returns for the category were more than 2 percentage points lower than reported total returns. Investors would have been better off simply buying and holding an intermediate-term bond fund.

What Works in Tactical Allocation

Granted, tactical asset allocation funds haven't been an unmitigated disaster. A few funds have been able to implement tactical approaches with a degree of success. For example, AQR Multi-Asset AQRNX uses a risk parity approach to balance risk between stocks, bonds, and inflation-sensitive assets and also makes tactical shifts based on AQR's models for value, momentum, quality, market sentiment, and other factors. Leuthold Core Investment LCORX has generated some of the category's best long-term returns by using a flexible approach to asset allocation that combines stocks, bonds, REITs, commodities, and money market instruments.

Some target-date fund series, such as T. Rowe Price Retirement and BlackRock LifePath Dynamic, have also successfully implemented tactical approaches to asset allocation. These funds typically keep any tactical tilts within a relatively small range, though, limiting the risk inherent in making dramatic portfolio changes.

Conclusion

Despite a few isolated success stories, the overwhelming body of evidence suggests that tactical asset allocation is detrimental to investors' bottom lines. Instead, investors are far better served by funds that maintain more-stable asset mixes, as well as by avoiding the temptation to make shorter-term shifts in their own portfolios. More broadly, tactical asset allocation funds are yet another example of why it's usually a bad sign when fund companies attempt to jazz up a basic concept: Like government bonds to government-plus and core bonds to core-plus or unconstrained bond, the evolution of strategic asset allocation to tactical asset allocation has been worse than the original, with costs going up and performance going down.