WEALTH MANAGEMENT

What Type of Asset Allocation Does an Investor Have and Want?

By Gene C. Sulzberger

Every industry has its jargon. The financial services industry is no exception. Two terms that many people do not understand are used quite often and are important in understanding how your money will be managed: strategic asset allocation and tactical asset allocation.

WHAT IS STRATEGIC ASSET ALLOCATION?

Strategic asset allocation is a portfolio strategy that involves setting target allocations for various asset classes, and periodically rebalancing the portfolio back to the original allocations when they deviate significantly from the initial settings due to differing returns from the various assets in the portfolio.

WHAT IS TACTICAL ASSET ALLOCATION?

The objective of tactical asset allocation is to actively rebalance the percentages of assets held in various asset classes within a diversified framework to seek to create additional return. Tactical asset allocation seeks to take advantage of market pricing anomalies in the different asset sectors. It is a process where the client's portfolio asset allocation is altered in response to changing future investment expectations.

Both strategies are based on modern portfolio theory, emphasizing diversification so as to reduce risk and volatility and ideally lead to better long term returns. The question remains which strategy should an investor choose, and the answer depends on the investor and his or her desires.

Strategic asset allocation may be appropriate for investors who want to see a mix in their portfolio that does not change with the markets. The client knows what the allocation of assets was at the beginning and they want to maintain that mix through all market conditions.

An argument against strategic asset allocation is that it does not allow for anomalies in the markets and can underperform the markets on a regular basis. Also, there is the argument that under a strategic asset allocation the portfolio manager may be buying into the top of the market and that the strategy puts nominal value on the value of what an investor buys.

Tactical asset allocation would be more suitable for investors who want to see their portfolio asset mix change as market conditions change and take advantage of asset class opportunities.

An argument against tactical asset allocation is that it has an emphasis on market timing. Some managers in this space may be too short term focused and investors may be impacted by tax and trading costs. This strategy could get expensive for an investor who pays their broker on a commission basis. Understanding these costs will be important to an investor engaged in a tactical asset allocation model.

I think it is important for investors to understand the strategy they currently have with their investment advisor. Questions to ask include the following:

1. Who makes the asset allocation decisions for my portfolio?
2. What is the skill set of the people involved in this decision?
3. Are the decision-makers independent and can they make unbiased decisions?

An investor's next steps include understanding the objectivity of the investment manager selection process. For example, is the team that is making the allocation decision related to the investment products that are being allocated to? Independence in the portfolio structure is important. In my opinion, an investor is best served when the investment manager selection process is independent and not clouded by conflicts of interest between the allocation process and investment selection.

Whichever process an investor chooses, understanding the differences is important.

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