HOW SHOULD YOU INVEST TODAY?
A TIMELESS APPROACH TO TACTICAL ASSET ALLOCATION

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In my last quarterly client letter (1Q2021) we discussed 'Strategic Asset Allocation', and how having an appropriate asset mix is far more important to your long term success than other factors such as attempting to 'time the market' and stock picking.

Strategic asset allocation sets an appropriate asset mix among stocks, bonds, and cash - as based upon your investment time horizon. At a minimum, your investment time horizon is to your approximate life expectancy, not to your retirement. (Key here, in the case of a pre-retiree, is the fact that your investment time horizon is not the same as the number of years remaining to your desired retirement age. A 60 year old who plans to retire at 65 may think they have a relatively short time horizon of just five years. But as any current retiree knows all too well, this is by no means the end of their investing years. Rather, a 60 year old today will likely be an investor, in some fashion, for decades to come. As such, an investor who is approaching retirement, or who has recently retired, is still very much a long term investor!)

A young investor (in their 20s, 30s, or 40s) who is decades away from retirement (let alone, to their life expectancy) will likely want to have all or most of their money invested in the stock market. This is to bolster their retirement savings, benefitting from the historical long term growth (above inflation and taxes) that only an equity portfolio can provide.

On the other extreme, an elderly investor (in their 80s or 90s) who relies on their portfolio for the income they require in order to live (food, housing, utilities, health care, etc.), may want to have far more of their portfolio in cash and bonds. The cash component provides the safety and liquidity they need, while bonds offer a steady and reliable income.

For those investors who are somewhere in between, they'll likely want a more 'balanced' approach. This typically applies to the 'pre-retiree' (i.e. someone who is within about 10 years before their retirement) or the 'newly retired' investor (who is within let's say 10 years after their initial retirement date). As mentioned above, these folks are still likely to be at least a decade or more away from their life expectancy - so in that sense they should still be considered long term investors. But when your retirement is 'just around the corner' you may not want to experience the market volatility that comes with a full-blown stock portfolio. And for those who have recently retired, and therefore are no longer contributing to their investments, they generally want to at least temper the huge (albeit temporary) drawdowns that an all-equity portfolio would otherwise expose them to.

That's where a 'balanced' portfolio comes in. As the name suggests, this typically involves a strategic asset allocation consisting of 50% stocks/50% bonds – or the classic '60/40' pension style portfolio (which of course, isn't exactly 'balanced').

So far we've reinforced the need for strategic asset allocation; an appropriate investment asset mix based upon your investment time horizon (as opposed to just 'winging it'). Makes sense. Simple enough, right? Well…not quite. And this is where tactical asset allocation comes into play.

While determining a prudent strategic asset allocation mix is a fundamental building block for any portfolio built for long term success – it ignores one thing: where are we today? More specifically, what does the current investment 'climate' and economy look like? Is it 'firing on all cylinders', when stocks are expensive and therefor risk is high? If so, we must position your portfolio more defensively, ever-mindful of the following quote from Warren Buffett's mentor, Benjamin Graham…

"A large advance in the stock market is basically a sign for caution and not a reason for confidence."

Or conversely, are we in the middle of a bear market or a recession, when stock prices are attractive and risk is low? In this scenario, we'll position portfolios more aggressively. As Warren Buffett has stated…

"Cash combined with courage in a time of crisis is priceless." and
"Bear markets are where the real money is made – not lost."

In either case, clearly part of my role as your portfolio manager is to 'keep my finger on the pulse of the market'. I may also describe this as 'taking the temperature' of the market, and adjusting your asset mix accordingly (so you don't have to). This is known as tactical asset allocation, and may also be referred to as 'dynamic' asset allocation.

Tactical asset allocation is a more active and dynamic approach. It allows me, your portfolio manager, the room to move within a percentage range for each asset class. This provides the flexibility needed to capitalize on changing market conditions and to seize investment opportunities as they arise.

Using the aforementioned "balanced" investor as an example, their strategic asset mix would typically be: 50% equities/50% bonds. By layering on the use of tactical asset allocation, seeking to take advantage of the current market environment, that same "balanced" investor may be willing to accept a range of as much as 70% equities and 30% bonds, to as little as 30% equities and 70% in bonds.

This is what legendary investor Howard Marks had to say on the subject of utilizing tactical asset allocation:

"While we can't see where we're going, we ought to have a good sense for where we are. It's possible to enhance investment results by making tactical decisions suited to the market climate. The most important is the choice between aggressiveness and defensiveness. These decisions can be made on the basis of observations regarding current conditions; they don't require guesswork about the future."

Key to this, and what differentiates our approach to that of the novice investor, is that there is no guesswork or forecasting involved. This is where most investors get it wrong. Far too many will position their investments based on what they think will happen in the future. Of course, the future is always unknowable…

"We have two classes of forecasters: Those who don't know, and those who don't know they don't know."

– John Kenneth Galbraith

Where are we now? To determine whether we should be aggressive or defensive with the positioning of your portfolio, I attempt to answer one fairly simple question: Are great businesses (…the ones we want to own!) attractively priced (i.e. cheap) or are they expensive? If we can own great businesses at temporarily low prices, we'll be more aggressive with your asset mix. And of course, conversely – when the businesses we want to own are priced at a premium – we'll be more defensive; underweighting equities in relation to your strategic mix, and overweighting cash and/or bonds. No guesswork, forecasting, or market timing required.

This 'contrarian' approach further differentiates us from the novice investor (i.e. the herd), who strangely and routinely gains more and more enthusiasm for stocks (AND, unknowingly, for risk) at market peaks? And in due course those same investors tend to sell equities at or near market bottoms, when great businesses are attractively priced, the risk is low – and therefor equities should be bought, not sold!

At the time of writing, most great businesses are definitely not "on sale", particularly in the U.S. Many of the factors I consider when determining an appropriate tactical asset allocation are flashing 'yellow' or 'red'. As such, portfolios as of today are generally positioned somewhat defensively. This is not to say that markets can't or won't continue to march higher. Of course, they absolutely can.

As your portfolio manager, I believe the important takeaway from this piece is to enforce the fact that you have both a strategic asset allocation AND a more dynamic tactical allocation strategy in place.

In closing I'd like to leave you with the following quote from Jeff Saut (former chief investment strategist with Raymond James Financial)…

"While NOBODY can consistently 'time' the stock market, if one listens to the message of the market, one can decide if they should be playing hard, or not so hard."

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