My Evolution on Asset Allocation

Earlier this week I wrote about how holding can be one of the hardest aspects of investing. Anyone can buy or sell but holding takes discipline. I promised a follow-up to discuss how I handle this.

To offer a potential solution I'm going to walk you through my evolution on how I've come to think about asset allocation over the years.

Concepts such as thinking long-term, buy and hold, value investing, and index funds were the proverbial light bulb ideas that made sense to me right away.

As I learned about other investment strategies over time I began to realize how important the behavioral and emotional aspects were for the entire process. Behavior trumps all because even the greatest portfolio or strategy in the world does you no good if you can't get yourself or your investors to stick with it. An interest in behavioral psychology led me to study more about financial history and market trends.

In a previous role in the institutional world, my firm had a subscription to Ned Davis Research. Davis has one of the more underrated minds and track records in the business. My colleague at the time was a quant who I helped systematically go through most of NDR's models and trading systems. After months and months of work, we discovered that the majority of the performance from these models could be explained by a single variable -- trend.

This is an oversimplification but if the trend was positive (based on some fairly simple rules), these models were in stocks and if the trend was negative the models would go to bonds or cash. Since stocks go up the majority of the time, the majority of the time these models were fully invested. But when trends broke to the downside, they got out.

As I became more interested in the idea of trends and momentum in the markets I began to read work from people and firms such as Cliff Asness (and his team at AQR), Wes Gray (and his team at Alpha Architect), Meb Faber, and Gary Antonacci (see the bottom of the post for some reading material from this group).

Momentum is based on the idea that assets that have performed relatively well (poorly) recently will continue to perform well (poorly) going forward, at least for a short period of time. The basis for this as an investment strategy is that the pendulum tends to swing too far in either direction because prices often dislocate from fundamentals. The historical data and research show that trends have existed pretty much everywhere in financial markets – stocks, bonds, currencies, commodities, etc.

The behavioral explanation for trends comes from our laundry list of biases. Research shows that investors hold onto losing stocks too long in hopes they'll come back to their original price while selling their winners too early. Investors also anchor to recent results, so initially, markets

underreact to news, events or data releases.

On the flip side, once things become apparent, investors enter a herd mentality and overreact, causing an overshoot to the upside. Fear, greed, overconfidence and the confirmation bias can lead investors to pile into winning areas of the market after they've risen or pile out after they've fallen.

In many ways, momentum investing acts as a counterweight to value investing, which is based on the long-term reversion to the mean. They just operate on different time frames.

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The problem for most investors is figuring out how to turn these ideas into a legitimate investment strategy. I've spent the better part of my career studying hedge fund and liquid alternative strategies. Although the idea of these funds makes sense (lower volatility, drawdowns, and correlations), the implementation is the hard part (a combination of high costs, high turnover, tax inefficiency, and leverage with a side of career risk to make them short-term focused).

As someone who has always tried to invest from an evidence-based perspective, it became really difficult for me to deny how powerful trend and momentum were in the markets. In many ways, I already knew this but never figured out how to incorporate these ideas in my investment philosophy.

In my mind, to turn trend-following into a strategy that works in the real world you have to figure out how to:

- Keep turnover relatively low for cost and tax purposes.
- Know how it generally works over a number of different market environments.
- Make it rules-based to take emotions out of the equation.
- Keep it liquid so you don't ruin the diversification benefits.
- Keep it simple because people have a hard time following and understanding complex approaches.

Enter my firm's Director of Research, Michael Batnick. Michael developed the strategy we use in-house that seeks to accomplish these goals.

To pull this off we utilize a systematic approach that follows pre-determined signals. We use low-cost ETFs to implement. On average, the strategy only trades once or twice a year.

The idea is that up trending markets tend to see much lower volatility and that's when you want to stay invested for as long as possible. Downtrending markets tend to see much higher volatility. The idea is not that we are trying to pick tops or bottoms. This system is not meant to miss every 5-10%

correction. Strategies that try to pull this off end up overtrading and underdelivering. The strategy is set up to avoid a 2008-type scenario where stocks drop 30-50%. You can never time these things perfectly but the goal is to miss most of the huge drawdowns.

Why should long-term investors even care about uptrends and downtrends?

Because this situational awareness allows us to prepare for a wide range of possibilities, without having to bet on any single outcome in advance. The most important thing to understand about downtrends is that they pave the way for a broader set of possible outcomes, and not always in a good way.

When markets start to fall, investors tend to panic, leading to a wider distribution of outcomes, including, but not limited to nasty market crashes. On the other hand, there are far fewer corrections or bear markets from up trending markets. Tail risk always exists, but it tends to be much larger when markets are in a downtrend because investors often make irrational decisions when losing money.

The strategy reduces equity risk during large market drawdowns and shifts from stocks to high-quality intermediate bonds. The goal is not necessarily to “beat the market” but to manage risk and help investors survive severe market downturns.

Understanding that ahead of time helps set the correct expectations. It gives you the possibility of outperforming but this is more about eliminating mistakes investors make during euphoric or panicked markets. All of my research has shown that these systems tend to give you similar returns to a buy and hold strategy but with a different volatility profile.

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This idea of tactical asset allocation will seem like blasphemy to many proponents of long-term investing but it doesn't have to be. I still think less is more, costs matter, and markets generally work over the long-term. In some ways, I see this as a balancing act between the two Nobel Prize winners in economics from 2013 -- Eugene Fama and Robert Shiller. Fama focused more on the long-term nature of how markets work while Shiller's work was on the behavioral aspects of the markets. Both are important if you wish to survive.

The combination of a strategic and tactical asset allocation is something I've definitely changed my tune on over the years. It doesn't have to be one or the other. You can marry the two together so they balance each other out. The tactical strategy is meant to further diversify the strategic asset allocation.

It's a way to diversify across time and market environment as opposed to the traditional view of diversification that simply seeks to diversify across asset classes. In some ways, it's just a form of

rebalancing, except this strategy seeks to over-rebalance to stock or bonds depending on the market environment.

Pulling this off requires that you allow competing ideologies into your portfolio. Combining the best of index funds, factor-based strategies and trend-following in a low-cost, globally diversified, rules-based portfolio is a great way to diversify by asset class, geography, and strategy. Nothing works all the time so this approach seeks to balance out those periods where one part of the portfolio is performing relatively poorly.

That's why I use this strategy as one piece of a broader portfolio. It's the same thing we do for clients. How much we use depends on the circumstances.

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To tie this all together back to my original point about convincing yourself to hold when markets get uncomfortable...this will always present a psychological challenge but it seems especially relevant in the current environment. I get these types of questions from investors on a regular basis these days:

- I have a big lump sum of cash -- What if I'm putting new money to work right before a crash?
- Valuations are high and interest rates are low -- How can I invest beyond traditional stock and bond strategies?

The strategy I've outlined here is one way to work through these issues but it's not for everyone. There's a huge difference between investors in the wealth accumulation and wealth preservation stages of their lifecycle. For those who have built a nice nest egg, I see a trend-following strategy as a way to survive any potential severe disruptions in the stock market.

It allows you to leave the rest of your portfolio alone so as to avoid selling out at an inopportune time. It can also provide dry powder for spending or rebalancing purposes.

The most important thing when implementing such a strategy is to set reasonable expectations up front. I know there are going to be periods where this strategy won't "work." You have to pay the occasional insurance premium in the form of whipsaw trades (getting out and then back in a short time later or vice versa). No tactical strategy I'm aware of -- and I've looked at them all -- has the ability to perfectly nail the timing on every trade.

The reason we use a rules-based system is because no one can predict when these huge downdrafts will happen in advance. We don't want to rely on intuition or gut instinct when trying to figure out when investors will get nervous.

Price and trend will tell us when that occurs and we will faithfully follow the rules until that happens. Having this strategy in place gives me more conviction to hold during a raging bull market because I know I have a plan of attack when it ends.

Everyone talks a lot these days about the importance of behavioral management to improve investment performance by avoiding mistakes. That's how I view this strategy in the context of my own portfolio and in that of clients that we work with.

Reach out if you're interested in learning more about how we do this at our firm:
Ritholtz Wealth Management

And here's a list of resources I have found helpful in this endeavor:

- A Quantitative Approach to Tactical Asset Allocation
- Where the Black Swans Hide & The 10 Days Myth
- Dual Momentum
- DIY Financial Advisor
- Avoiding the Big Drawdown: Downside Protection Investment Strategies
- A Century of Evidence on Trend-Following Investing
- How We Do Tactical