Tactical Asset Allocation in Today's Market?

Understanding relative strength (momentum) and counter-trend analysis

Wise investors alter their approaches as market cycles shift, from bull to bear to something in between. A consistent strategy can be far more risky than one that involves tactical shifts according to the season.

Take my 13-year-old son, who loves wearing shorts and a T-shirt. He loves this so much that he wears the skimpy attire all year-round, no matter how cold it is outside. He does this for two reasons:

1. That is the style now.
2. He is 13 and just doesn't know any better.

He reminds me a lot of how individual investors behave. They follow a traditional asset allocation/buy and hold approach, regardless of what the market is doing. This, and any other strategy, works fine in a bull market, just like wearing shorts and a T-shirt is fine during the summer. But it gets you crushed in a down market.

Three Types of Markets

There are basically three different types of markets, each requiring its own investment strategy:

So-easy-a-caveman-could-do-it market.
In such bullish times, the market goes up in a straight line. Even someone with a brain the size of a walnut could make 20% per year (apologies to any cavemen reading this, if you can read, that is).

The markets in 2019 and 2021 are two great examples. In these types of markets, just about anything that you invested in worked well. This is true with an asset allocation or a trend-following tactical strategy.

Bear market.
This is one that goes down a lot. Great examples of this were from 2007 – 2009 when the S&P 500 lost more than 50% of its value over 16 months or the COVID-19 induced bear market that cut over 30% from the S&P 500 in a very short period of time (it was also the shortest bear in history).

Just about any strategy that has you fully invested in equities gets hurt in this type of market. This is just like my son wearing shorts in the dead of winter: He feels comfortable because everyone is doing it, but he is freezing his butt off. In this market, a better strategy might be where an investor is in cash and maybe short-term bonds.

Risky market.
Here, volatility is high, which produces some returns

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but is at great risk of falling into a slump. The current cycle embodies this. While the market has gained some but lost more throughout the year, the risk is still immense.

Volatility is low at the moment, yet any bad news from anywhere – Ukraine, the Fed, inflation, supply chains – can change that in a jiffy.

Although a fully invested strategy in this market could work out OK, the risk might not be worth it. This is like my son wearing shorts in the fall: If he gets a warm day he is fine; if he doesn't, he gets really cold.

Tactical Asset Allocation

Tactical could be the way to go in this market. A good tactical strategy often trails a fully invested approach if the market is going up in the face of great risk (albeit with much less volatility). But it protects you if the risky market turns bearish.

With this strategy, known as Tactical Asset Allocation, you alter the mix of your assets based on their price performance. You favor asset classes trending upward, and unload those going down. TAA has two methods:

1. Relative strength, also called momentum, has you buying the strongest investment from a basket of two or more asset classes. That could be stocks and bonds, or U.S. shares and international ones.
2. Counter trend analysis entails buying into short-term weakness and selling into short-term strength. This is not market timing, which involves predictions. Market timing tries to get out at market tops and in at market bottoms.

TAA only moves when a trend is clear.

Talk to your advisor to see which might make the most sense for you.

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