

Asset Allocation for a World Where Interest Rates Don't Always Go Down and Stocks Don't Always Go Up

Tuttle Capital Management



Introduction

Those who follow our work know that I think the idea of Asset Allocation (AA) is problematic. When I started in financial services in the 1990s, one would work with a broker (there were no financial advisors back then) to make money. There was no talk of the S&P 500 and it didn't matter what the Dow was doing. At some point the paradigm changed and working with a broker or advisor meant creating a globally diversified portfolio that matched one's risk tolerance and goals. I would argue that this change was not due to brokerage firms realizing that asset allocation was better. Instead, I think they realized that fee-based compensation was better than commission based for their bottom line.

I believe there is some benefit to investors being agnostic between long and short, day trading and swing trading in a bear market, and buying breakouts in a bull market. Unfortunately, this is not possible for most and certainly not possible for financial advisors who spend their day running a business and talking to clients, not trading markets. So for most people, some sort of AA can be the best approach.

But here's the potential problem: not putting all your eggs in one basket can be frustrating when all of your baskets are losing money. The key issue is that AA is built on the idea that bonds are uncorrelated with stocks and are a risk reducer. This idea is based on the past 40 years of interest rates going down, but once/if rates start going up, this idea falls flat. Further complicating matters is that rising interest rates tends to be bearish for the stock market, meaning we could experience years like 2022 where everything seems to go down together.

Tactical Asset Allocation (TAA)

In 2008 a new idea started to gain prominence: Tactical Asset Allocation (TAA). The idea was compelling. One rides the market up and then gets out as the market is going down. When markets go up or down in a straight line, TAA can work as advertised. Unfortunately, markets rarely move in straight lines. More often they are choppy, which can destroy TAA strategies. I monitor tactical mutual funds and ETFs and most of them have performed poorly in 2022, a year when sponsors would have expected them to excel.

Given the choice of spreading one's proverbial eggs to different baskets that can all potentially go down at the same time or using some sort of algorithm to switch between baskets, spreading is, in my opinion, probably the lesser of two evils, but it is far from ideal.

Solution

In my view, the solution is to use what's beneficial about both Asset Allocation and Tactical Asset Allocation. The biggest potential problem with TAA is that the basic strategy attempts to move between stocks and cash, or stocks and bonds. In a choppy market investors using TAA can end up getting whipped around. Another possible risk with AA is allocating money to fixed baskets and having those baskets become correlated on the downside.

Instead, consider having a number of different baskets and be *somewhat* tactical within them.

For example, let's take a stock basket. TAA would say to move between stocks and cash (or stocks and bonds), which is great if you are right and a big problem if you are wrong. AA would just allocate among a number of different areas of the market and be pretty static. This is also not ideal. A different approach would be to break stocks down by the two only real areas that matter: low beta and high beta. Forget about all the factors and styles; those are more about marketing than making money. At its core, money moves between low beta (volatility) and high beta stocks. During risk-off environments, fully invested portfolio managers move to the stocks they perceive as safer. During risk-on, they move to the areas that have higher risk and potentially higher return. Your stock basket can mimic that behavior. With TAA, if you are wrong it can be devastating. In a more flexible approach, being wrong means you probably just underperform the market by a bit. You can set up a basket where most of the time you have an allocation to both areas, making the most dramatic shifts during major risk-on or major risk-off markets. You can also apply a weighting mechanism. My favorite is using maximum drawdown, so the area with the largest drawdown recently gets the lowest weighting. As an aside, the industry likes to use standard deviation as its preferred risk measure. Standard deviation just measures how much something fluctuates around its mean. High standard deviation isn't necessarily a bad thing. Drawdown is maximum peak to trough loss. High drawdowns are a bad thing.

A similar approach can be taken with bonds, but bonds are a bit different and should be treated as such. First, I believe the only types of bonds that really matter are Treasuries and TIPs. Other types of bonds have elements that correlate them somewhat to stocks. Just like stocks, Treasuries have risk-on and risk-off also, but in the case of bonds we're talking about duration. Longer duration (sort of maturity) bonds are more sensitive to changes in interest rates and flight to safety. In thinking about a bond basket, one could move around between longer and shorter duration bonds based on what's going on with interest rates.

The next basket can focus on multiple asset classes. Instead of all or none, or fixed allocations, one can come up with a group of asset classes and then pick the top few to allocate to. One can then weight by maximum drawdown. Cash could be part of this basket, but based on what is being picked and the weighting, cash would never be 100%. Things I like to include here are US stocks, emerging market stocks, international stocks, small cap stocks, Gold, commodities, real estate, and managed futures.

The next basket can be an alpha basket. This is where one can put portfolio managers or strategies that can add alpha. Be careful here, though. Return is not alpha. You don't put something in this basket just because it is doing well. You need to ask yourself why it is doing well and whether it is sustainable. You could put TAA strategies in here and/or any other strategy or manager you believe is likely to generate alpha.

Finally, we can create a tail risk basket. The best thing to own to protect from tail risk is volatility (VIX). VIX basically measures the volatility of the S&P 500. During times of stress, volatility increases, and sometimes it can increase a lot. Unfortunately, you cannot invest in spot VIX. The best way to get exposure is through VIX ETPs, which structurally can leave much to be desired. However, they do work as advertised, and during times of stress they will spike. Unfortunately, during any other time, they will most likely bleed. What we like to do is

combine VIX with SPY and dynamically weight by most recent total return (you can't use maximum drawdown weighting with VIX as it is always going to be too high to get a meaningful weighting). The SPY weighting can offset most, if not all, of the VIX bleed. You can't expect much upside from the strategy over time, but during periods of stress it can really help. Given that, I think it should never be more than 5% or so of a portfolio.

Once we have all of our baskets, we can weight according to our risk tolerance. The stock basket, and perhaps the alpha basket are going to be the most volatile, while the bond basket will be the least volatile. I like to set baskets up so that they rebalance internally on a monthly basis, so your allocation to the baskets can be static because internally they will add or reduce risk accordingly.

This approach combines the best parts of AA and TAA into an allocation strategy that aims to work regardless of the market environment.

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