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UBS on the new financial world

Understanding the differences between strategic and tactical asset allocation

The market crisis has caused heightened confusion with regard to the differences between strategic and tactical asset allocation. A clear understanding of their distinct yet complementary roles has never been more important.

In the wake of two years of dramatic market turmoil, it seems that even the most basic tenets of investment strategy are open for debate. Simple notions such as diversification and rebalancing are no longer taken for granted. There is a loud chorus proclaiming that asset allocation is broken. Steep declines in the equity markets, commodity markets, real estate markets, etc., mandate a substantial revision of asset allocation models—or so the current logic goes. Of course, if you probe what type of revisions people have in mind, some will say that dramatically higher returns must follow such a steep market decline. Others will say that the world has changed for the worse and that substantially lower returns should be expected. These responses uncover a fundamental confusion among many investors with regard to the distinct roles of both strategic asset allocation (SAA) and tactical asset allocation (TAA).

We therefore seek to clear up some of this confusion by providing some basic information on SAA and TAA, and how it is that they differ. We will start by discussing the general framework for both and then demonstrate the complementary role that each plays in the investment process. We will then address differences in the time horizons and associated divergences in expected return assumptions that help distinguish SAA and TAA from one another. Finally, we will explain why these differences should work in tandem to provide a well-diversified portfolio aligned with pre-defined risk tolerance levels, but also help investors to both benefit from—and protect against—short-term market fluctuations.

Insights from UBS Investment Solutions

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Strategic asset allocation

A strategic asset allocation specifies the proportion of various asset classes in a portfolio designed to provide an investor with an appropriate risk/return profile over a longer period of time. A strategic asset allocation framework will specify a range of allocations appropriate for various levels of risk tolerance. For example, those with lower risk tolerance will tend to have lower exposure to more volatile, higher-risk assets such as stocks and commodities, and higher allocations to less volatile, lower-risk assets, including bonds and cash. Lifecycle changes may impact an individual's risk tolerance, which may at times suggest an adjustment to an individual's strategic asset allocation. However, the long-term nature of strategic asset allocation implies that changes should take place infrequently.

Strategic asset allocation is driven by long-term return and risk expectations for various asset classes.[1] One of the key reasons why strategic asset allocations don't often change is that the long-term risk and return expectations that are the basis for those allocations don't often change either. Although markets tend to be volatile and returns often diverge sharply from year to year, viewed over the longer term, the returns tend to become more stable, with gains in some years offsetting losses in other years. This suggests that the return and risk assumptions that form the framework of the strategic asset allocation process should be periodically evaluated and modified when the investment landscape has a material change, e.g., a shift in longer-term growth rates, a change in inflation expectations or a shift in risk premiums.

A robust process of estimating long-term risk and return expectations should therefore not be unduly impacted by near-term activity. In fact, frequent changes to long-term risk and return expectations could seriously undermine the investment discipline provided by a strategic asset allocation framework.

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[1] The correlations among asset classes are key ingredients as well, but to keep this paper from becoming a primer on portfolio construction, we will leave much of that topic to other forums.

Tactical asset allocation (TAA)

The right place to take into account near-term market activity is within a tactical asset allocation framework, which is designed to identify opportunities to periodically tilt the strategic asset allocations. Whereas the key drivers of strategic asset allocation are long-term risk and return expectations for various asset classes, tactical asset allocation focuses on such drivers as valuation, momentum, sentiment, the business cycle, and fiscal and monetary factors, among others, to identify asset classes that are expected to outperform in the near term or underperform their longer-term expectations.

Temporary overweighting or underweighting of components of the strategic asset allocation can help enhance performance over time. This includes not only overweighting those asset classes or sectors that may provide better near-term return prospects, but also underweighting those that appear overvalued or are vulnerable to near-term event risk. These tactical allocation decisions vary with much greater frequency than changes in the strategic asset allocation weightings. However, even tactical rebalancing must be done in a disciplined manner, with consideration of the benefits, risks and costs.

Complementary strategies

While strategic and tactical asset allocation differ, they work as complementary components within a comprehensive investment framework.

Strategic asset allocation		Tactical asset allocation	
Description	A series of baseline portfolios appropriate for various levels of risk tolerance in a "neutral" state of the world	**Description**	Periodic "tilts" to baseline portfolios in response to market conditions with the object of increasing return and/or reducing risk
Time horizon	Long-term	**Time horizon**	Varies - Short-term: several months (trading ideas) - Medium-term: six months to two-three years (thematic ideas)
Key drivers	Risk and return expectations for various asset classes	**Key drivers**	Valuation Cyclical analysis (economic, earnings), timing, market sentiment

A solid investment strategy highlights the role of both strategic and tactical asset allocation by specifying a strategic asset allocation as well as identifying a range for each component that specifies the boundaries of tactical overweighting or underweighting. The table below provides a simple example to help illustrate the distinguishing features of strategic and tactical asset allocation.

	Strategic asset allocation	Tactical range
U.S. equity	35%	25% – 45%
Non-U.S. equity	25%	15% – 35%
Bonds	35%	25% – 45%
Cash	5%	0% – 15%

The strategic asset allocation provides the anchor to help ensure that long-term investment objectives are met, while the tactical range determines the magnitude of acceptable tactical "tilts."

Conclusion

While strategic and tactical asset allocation may differ in terms of time horizon and key drivers, they must be viewed as complementary components within a comprehensive investment framework. At UBS, we work to deliver a well-crafted and consistent strategic asset allocation framework, as well as high-quality, research-driven tactical asset allocation recommendations.

For additional details regarding our strategic asset allocation framework, please speak with your UBS Financial Advisor. Tactical asset allocation guidance is delivered monthly in Wealth Management Research's *Investment Strategy Guide*.

UBS strategic asset allocation models are developed by UBS Investment Solutions, a business sector within UBS Wealth Management that develops research-based traditional investments (e.g., managed accounts and mutual fund programs) and alternative strategies (e.g., hedge funds, private equity and real estate) offered to UBS clients. Allocations have been developed for seven different Investor Profiles that reflect general characteristics (e.g., risk tolerance, return objectives and time horizon) of hypothetical U.S. investors. The return and risk capital market assumptions used in developing the UBS strategic asset allocation models are developed by UBS Global Asset Management, a subsidiary of UBS AG and an affiliate of UBS Financial Services Inc. UBS tactical asset allocations are developed by UBS Wealth Management Research (WMR), a business sector within UBS Wealth Management, whose primary business focus is institutional investors. Opinions expressed by WMR may differ or be contrary to those expressed by other business areas or divisions of UBS as a result of using different assumptions and/or criteria.

Source: UBS Investment Solutions. Information regarding strategic and tactical asset allocation is presented for informational purposes. Note that asset allocation does not assure a profit or guarantee against losses in declining markets.

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