Global Tactical Asset Allocation: Overview of an Investment Strategy Growing in Popularity

Heightened global market volatility over the last decade and multiple economic recessions are forcing investors to become more risk averse and search for investments that are less correlated to traditional equity or fixed-income markets to diversify risk and protect their portfolios from material capital drawdowns. Moreover, the extraordinarily low interest rates offered on bonds increases the need for investors to find a stable return substitute for fixed income.

Consequently, substantial investor capital has found a home in global tactical asset allocation (GTAA) strategies, as these strategies provide asset diversification and downside protection through a tactical, multi-asset/geographic portfolio approach. Growth in the number of GTAA managers and strategies has been significant over the past two decades, with over 150 GTAA strategies in existence today. This has led to a proliferation of different GTAA investment approaches, making understanding, evaluating, and investing in GTAA a daunting task for many investors.

This Investment Insight presents an overview of GTAA, along with the benefits and drawbacks of investing in this type of strategy. It also examines and compares GTAA performance and investment structure relative to other alternative investments, including hedge funds of funds, global macro funds and commodity trading advisors (CTAs). Although there are similarities to these alternative investment strategies, this publication will highlight the key differences from GTAA.

Evolution of GTAA Investment Styles

GTAA investing evolved from tactical asset allocation (TAA), which emerged in the 1970s to offer a solution to investors wanting tactical exposures to multiple asset classes, typically shifting between U.S. stocks, bonds and cash. As global markets matured, TAA managers began adding country allocation decisions within and across asset classes, in addition to traditional asset class timing, thereby creating a global TAA investment approach, or GTAA. Although many of these strategies used passive vehicles when implementing their asset class exposures, in the 1990s, GTAA strategies shifted toward more active management. Today, GTAA broadly refers to managers that take long-term or short-term views on market trends by investing tactically across equities, fixed income, commodities, currencies and real estate. As a result, GTAA managers have increasingly been used to complement a core balanced asset allocation and to provide portfolio diversification in a vehicle that is sensitive to macroeconomic issues around the world. Segal Rogerscasey has identified the following main GTAA investment styles:

- **Directional Strategies**  Directional GTAA managers express views on a particular market or markets, often resulting in a tilt toward one or more asset classes, such as equities, fixed income, commodities or real estate. The volatility experienced in such strategies will depend upon the manager’s tilts.

- **Blend Strategies**  Balanced GTAA managers focus on a traditional blended portfolio across equities and fixed-income investments, with lower allocations to other asset classes such as real estate. The resulting volatility is often between fixed income and equity-market volatility.

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1 eVestment Analytics
**Completion Strategies** Completion GTAA managers provide exposure to assets not found in a traditional 60/40 portfolio, such as emerging markets debt or Treasury inflation-protected securities (TIPS). Completion strategies may have exposure to non-traditional or alternative asset classes, such as hedge funds and private equity, or they may be inflation-focused, with more exposure to commodities, real estate and TIPS.

Within these main styles of GTAA investing, each manager’s investment process may differ. Some managers are highly systematic, using quantitative processes to determine what the asset allocation should be, while others take a fundamental approach, incorporating global trends, macroeconomic themes and qualitative opinions into the process. Others combine the two approaches, using a top-down, macroeconomic viewpoint to guide the investment process, and then conducting bottom-up analysis to identify specific positions that will express those views.

**Risk-Parity vs. GTAA Managers**

Risk-parity strategies, while not a sub-category of GTAA, are often compared to GTAA, as managers of each strategy attempt to provide downside protection through a multi-asset portfolio. However, risk-parity managers attempt to construct portfolios of multiple asset classes to target a particular risk profile rather than tactically shifting between asset classes to maximize return. A common approach of risk-parity managers has been to balance the risk contributions from each asset class within the portfolio, often resulting in a portfolio with lower allocations to higher risk assets (equities) and higher allocations to lower risk assets (fixed income). Leverage is typically used on the lower risk assets to raise the portfolio to a desired level of predicted volatility.

**Implementation**

Beyond investment style, GTAA managers can be differentiated by the instruments they use to implement their strategies. These might include one or more of the following approaches:

- **Fund of Funds** This implementation approach sets the overall asset allocation targets, but then invests in the underlying actively managed funds of the investment firm in order to leverage the capabilities of existing teams across asset classes.

- **Exchange-Traded Funds (ETFs)** This implementation approach is desirable for managers seeking liquidity and speed in execution as well as cost savings in certain asset classes.

- **Derivative Instruments** This implementation approach allows for ease in increasing or decreasing the asset-class exposures of the strategy in a cost effective and liquid manner and may include the use of futures, options, swaps or other derivative instruments.

**Investing in a GTAA Strategy**

Despite the many options, there is no one “right” way to implement a GTAA strategy. The essential steps to selecting the best approach for a particular investment plan, however, are determining the appropriate risk/return targets of the total portfolio, followed by examining what gaps may currently exist and finally deciding which GTAA style will best complement and enhance the existing portfolio.

Investors have used GTAA strategies as an alternative to hedge funds of funds, global macro funds or commodity trading advisors (CTAs) to provide a unique source of returns. Some investors are now earmarking portions of their overall alternatives allocation to GTAA mandates. However, while there are similarities between GTAA managers and other alternative asset managers, there are some major differences that should be noted.

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1 A forthcoming issue of Investment Insight will focus on risk parity.

2 Leverage refers to the sum of the notional or principal exposures of underlying financial instruments, such as options and futures, divided by the total portfolio assets.
GTAA Compared to Other Alternative Investments

GTAA managers invest in many of the same asset classes as global macro funds, but typically offer more liquidity and transparency, and invest with stricter investment guidelines. A brief comparison of the liquidity profiles of a number of multi-asset class investment choices is shown in Table 1.

GTAA: Downside Protection

In 2008, GTAA managers “outperformed” major equity markets by returning a significantly lower loss: −20 percent compared to −41 percent for the MSCI World Index. Moreover, the tactical nature of GTAA managers allowed the strategy to recover these losses much faster than most traditional asset or hedge funds of funds managers, as illustrated in Graph 1. After the market

\[\text{Graph 1: Growth of } $100 \text{ Invested, January 2008 - December 2011}\]

* GTAA performance is comprised of GTAA strategies from Segal Rogerscasey’s non-proprietary database.

** Commodity Splice, a Segal Rogerscasey index, blends the DJ UBS Commodity Index (50%) and the S&P GSCI Index (50%), rebalanced monthly.

Source: eVestment Analytics, using data from Hedge Fund Net
downturn in 2008, GTAA managers on average were able to recover assets to original levels by March 2010, while hedge funds of funds, global stocks and commodities had not yet fully recovered assets through December 2011. Recent investor interest in GTAA can be partially attributed to this outperformance and downside protection.

When examining average monthly performance, this downside protection continues to be apparent. Graph 2 shows that GTAA managers’ average positive monthly performance was 2.2 percent, which is below global equities’ 3.5 percent, but above hedge funds of funds and global macro funds. In down months, however, GTAA managers’ returns averaged –1.9 percent, beating major market indices, though not providing quite as much downside protection as certain other alternative investments. This can also be seen in Graph 1, where the performance of global macro funds and CTAs did not have as large of a drawdown as GTAA managers.

![Graph 2: Average Up/Down Month Returns 1995-2011](image)

GTAA Historical Performance

While GTAA managers have garnered interest due to their flexible investment approach and attractive return streams, a closer look at performance can highlight key areas of strengths and weaknesses within GTAA investing.

The most positive characteristic many attribute to GTAA managers is that their diversified portfolios deliver uncorrelated returns. However, it is hard to see this benefit when examining historical performance. Table 2 shows that GTAA managers as a whole tend to exhibit high

**Table 2: Selected Asset Classes Correlation Matrix: 1995-2011**

<table>
<thead>
<tr>
<th></th>
<th>MSCI World</th>
<th>Commodity Splice*</th>
<th>Barclays Capital Aggregate Bond Index</th>
<th>GTAA Managers**</th>
<th>HFN HFOF Multi-Strat</th>
<th>HFN Global Macro</th>
<th>HFN CTAs</th>
</tr>
</thead>
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<tr>
<td>MSCI World Index</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Commodity Splice*</td>
<td>0.34</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Barclays Capital Aggregate Bond Index</td>
<td>0.00</td>
<td>0.04</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>GTAA Managers**</td>
<td>0.94</td>
<td>0.45</td>
<td>0.13</td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>HFN HFOF Multi-Strat</td>
<td>0.65</td>
<td>0.48</td>
<td>0.05</td>
<td>0.75</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>HFN Global Macro</td>
<td>0.48</td>
<td>0.35</td>
<td>0.19</td>
<td>0.59</td>
<td>0.77</td>
<td>1.00</td>
<td></td>
</tr>
<tr>
<td>HFN CTAs</td>
<td>0.05</td>
<td>0.32</td>
<td>0.27</td>
<td>0.19</td>
<td>0.36</td>
<td>0.60</td>
<td>1.00</td>
</tr>
</tbody>
</table>

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** GTAA performance is comprised of GTAA strategies from Segal Rogerscasey's non-proprietary database.

Source: eVestment Analytics, using data from Hedge Fund Net
correlation with major equity indices over hedge funds of funds, global macro funds and CTAs. Due to the fact that most GTAA strategies are long-only strategies and use only the most liquid public instruments, this higher correlation over other alternatives is not surprising. However, it should be noted that correlations may vary depending on the particular strategy or style the GTAA manager chooses to follow. As with any investment strategy, manager selection is key.

Performance metrics shown in Table 3 highlight the appeal of GTAA strategies. Annualized return averaged 10.3 percent over the observation period, higher than most major market indices.\(^5\) However, volatility was generally lower than other investment categories, resulting in a Sharpe ratio of 0.8, comparable with hedge funds of funds, which also had a Sharpe ratio of 0.8.\(^6\)

While GTAA managers had better risk/rewards statistics than many major market indices during the period shown, they also exhibited higher negative skewness.\(^7\) GTAA managers have produced an average skew of −1.3, less favorable than major market indices and other alternative investments listed in Table 3. This negative skew, combined with a higher kurtosis\(^8\) (fat tails), implies that there is a greater probability that GTAA managers may deliver larger negative returns as compared to other alternative investments. This is apparent when examining the maximum drawdown\(^9\) of GTAA managers: −26.0 percent, which while better than major market indices, underperforms hedge funds of funds and global macro funds, whose maximum drawdowns are −19.4 percent and −6.7 percent, respectively. Therefore, while GTAA managers do have the ability to be flexible in times of market distress, they may still be subject to major market movements that more alternative managers may protect against, albeit at an incremental cost due to a higher fee structure. Hedge funds of funds, global macro funds and CTAs, which are not subject to the same liquidity, risk and leverage requirements, may be able to deliver more alpha\(^10\) as a result.

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\(^5\) The data was examined using the longest common history available with a significant number of data points, dating from 1995 through 2011.

\(^6\) "Sharpe Ratio" is calculated by dividing the excess performance above the risk-free rate by the standard deviation of the portfolio. It is commonly used as a return/risk measure, with a higher Sharpe Ratio preferred.

\(^7\) "Skewness" refers to the probability distribution of a manager’s returns being more tilted towards negative values. A positive skew is more favorable over a negative skew.

\(^8\) "Kurtosis" defines the distribution of values surrounding the mean. A higher kurtosis refers to more values at the end of the probability distribution (also referred to as "fat tails"), implying that extreme values are more likely.

\(^9\) "Maximum drawdown" refers to the largest peak to trough returns over the history of a manager.

\(^10\) "Alpha" is a measure of performance comparing the risk-adjusted returns of a manager above a stated benchmark.
Investment Structure

Most GTAA strategies are established within broader investment management firms and are thus more likely to have tighter risk controls and wider resources dedicated to the product as compared to smaller hedge funds. By leveraging the firm’s back office infrastructure, risk-management capabilities and deep research teams, GTAA strategies can be implemented in client-friendly structures with which traditional investors are already familiar. GTAA strategies are often available as collective investment trusts or mutual funds, thereby creating additional regulatory, transparency and liquidity requirements. This additional layer of scrutiny offers investors protection when investing in GTAA strategies that may not be available in more other alternative investment vehicles, which are organized as closed end private funds, and can drastically reduce the due diligence needed over unregulated vehicles.

The ability to easily scale up or down risk is another key attribute of GTAA managers, as most funds offer daily liquidity. This, along with other features, means GTAA managers are typically able to charge a more traditional management fee without charging a performance fee. This is in contrast to hedge funds or hedge funds of funds, which typically charge a management as well as a performance fee. As hedge funds often target a higher risk/return profile and focus on highly active portfolio management, this provides both the incentive for managers to outperform and justification for the performance fees.

GTAA: A Complement or a Competitor?

As highlighted previously, GTAA managers offer the benefits of diversification in a liquid and cost effective format. However, performance statistics indicate that less than perfectly liquid strategies such as hedge funds of funds, global macro funds and CTAs have provided higher alpha, thereby suggesting GTAA managers simply offer a different risk/return stream and should not be considered a substitute. Instead, perhaps GTAA may be considered as a companion to these alternative hedge fund strategies, by offering a complementary tool to help protect portfolios in multiple market periods.

Further examining this concept, Graph 3 displays the 12-month rolling excess returns of various alternatives. The benefit of investing in GTAA managers can be seen leading up to and through

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Graph 3: 12-Month Rolling Excess Returns 1996-2011

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Source: eVestment Analytics, using data from Hedge Fund Net
recessionary periods, where they have greatly outperformed the less than perfectly liquid alternatives. However, in bull market periods such as the mid to late 1990s, GTAA managers have underperformed, highlighting the ability of global macro funds and CTAs to act more aggressively and provide excess returns. Each manager may also use derivative overlays to make long and short bets across asset classes and geographies, though the degree of usage can vary. The historical evidence suggests that each strategy has periods of over and underperformance that do not perfectly overlap, so strategically allocating to both could provide optimal portfolio positioning.

Conclusion

GTAA managers offer investors a tool to mitigate portfolio asset allocation risk while potentially reducing overall portfolio volatility and offering an uncorrelated source of returns. Many strategies are not benchmark-driven, which allow GTAA strategies to be more opportunistic when compared to traditional equity, fixed-income or commodity managers. Moreover, GTAA managers offer investors features of alternative investment funds, such as hedge funds of funds, global macro funds and CTAs, but at a lower fee schedule and with heightened regulation, transparency and liquidity. The diversity and range of GTAA strategies also allows investors to select the most appropriate GTAA strategy for their particular portfolio.

However, while GTAA strategies overlap with alternative investment strategies, they should not be thought of as an exact proxy. Global macro funds, CTAs and hedge funds of funds may be able to offer additional alpha over the long-term and provide concentrated exposures to certain asset classes as well as uncorrelated sources of returns. In examining performance, GTAA strategies appear to serve as a good complement to these less than perfectly liquid strategies, therefore allocating to both GTAA and alternative strategies could be beneficial for long-term performance.

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Questions? Contact Us.

For more information about GTAA and to discuss how it might be used in your investment portfolio, contact your Segal Rogerscasey consultant, the nearest Segal Rogerscasey office (www.segalrc.com/offices) or Nimisha Patel at 212.251.5087 or npatel@segalrc.com.

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