



CLIENT-CENTRIC INVESTING: UTILIZING TACTICAL MANAGERS TO IMPROVE RISK/RETURN

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Characteristics of Client Portfolios

The most common method for building multi-asset portfolios is based on Modern Portfolio Theory (MPT). The biggest issue we have with this approach is that it is not aligned with most investors' view of risk. MPT utilizes a process that seeks an efficient portfolio with a given level of risk measured by return volatility. This misalignment manifests itself when the market is down 36%, and a portfolio is down 33%. In this case, the manager is patted on the back (receives a bonus) for outperforming their benchmark, and the investor is out 1/3 of their investment.

At RPg, we have always defined risk as how much an investor is willing to lose in a short period of time (maximum drawdown) before they are unwilling to stick with their long-term plan. Moreover, we think the biggest risk facing investors is not the short term volatility of returns, but the risk of an investor outliving their wealth. Minimizing the times an investor may make an emotional decision to move away from their long-term plan can help them stay on the long-term glide path, giving them the highest probability for successfully funding through their entire retirement.

This point is complicated because there are two long phases an investor goes through when planning to fully fund retirement. The accumulation phase, when the investor is earning a salary and saving, which can last 40 years. And the distribution or consumption phase, when the investor is spending from the pool of capital they saved and invested with, which can last 30 years or more.



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As Chart 1 depicts, the last 60 years the stock market (as measured by the S&P 500) has averaged just over 16 times earnings, but there have been times when the S&P has traded far above 16 times earnings, and far below. The solid white line represents the 60 year average price to earnings (PE). The return expectations when the market is at 30 times earnings will be different from when the market is trading at 8 times earnings and those entry points can lead to very different glide paths to a fully funded retirement.

Another aspect of Chart 1 is that it shows the mean reverting nature of valuations. Valuations may not be a great predictor of returns over the short term, but over a full economic cycle, the importance of valuation steadily increases. With MPT, the investor's decision process for how much risk they are interested in taking for a stated return target gets complicated, as MPT is limited to a single period optimization.

Chart 1 - S&P 500 Price/Earnings 12/31/1954 – 12/31/2013



Valuations and returns are not constant in the stock market. We do not assume a market that is trading at 30 times earnings, as it was in late 1999, could achieve similar 10-year returns to a market trading at 7 times earnings, as it was in 1982. Because of the long-term nature of retirement planning, we think it is important to approach building a multi-asset portfolio tactically. Aligning an investor's risk exposure with some explicit adjustments depending upon when valuations are rich as well as when they are cheap. As an example, a static approach to asset allocation would be harmful to an investor who turned 55 years of age in 1961. This investor would have a higher allocation to stocks when valuations are rich, and by the time this investor turns 70 years of age, their portfolio would have rotated largely into bonds just before a multi-decade bull market in equities.

What is tactical investing?

Tactical investing can involve quantitative models that are used in an effort to remove cognitive biases that enter the investment decision making process, limit losses, and reduce volatility. Many strategies look and sound logical and have mass appeal especially at times when investors have fresh memories of significant market declines and multi-year bear markets that decimated portfolio values.

This “present bias” happens when we feel more compelled by the data that is in front of us now than by what is coming in the future. Employing a rules-based investment methodology for a portion of an investor’s multi-asset portfolio can help remove the “present bias”, and may help keep investors on their long-term glide path.

How to go about expressing a tactical “sleeve” to a portfolio is another question. Even the best thought out tactical solution is going to have an Achilles heel, or some form of kryptonite when the strategy does not work. By utilizing just one type of tactical solution, a portfolio will suffer by not diversifying the cognitive input to that sleeve. By tapping into the collective intelligence of a diverse set of tactical managers (seeking cognitive diversity), a portfolio will have a higher likelihood of enjoying the benefits the tactical space works so hard to deliver; a systematic approach to reduce volatility, and loss avoidance.

The managed futures asset class was one of the first to be included in an allocation for these purposes and the most common method for inclusion of this asset class was to have more than one commodity trading advisor (CTA) in the “sleeve” for managed futures. This makes sense as an investor was able to utilize a collection of managers who looked at the world through a diversified set of lenses. An investor would not have to be right about the long-term trend follower doing better than the intermediate or short-term trend following CTA. With many of the offerings an investor would get access to all three.

The benefit of this way of allocating to an asset class is that it includes people looking at data from different perspectives seeking a better outcome. At RPg, we think the financial services industry would be well served by approaching the tactical manager space the same way. This could yield a portfolio that allows an investor to stay on track minimizing the risk of a shortfall in retirement.

What to expect moving forward

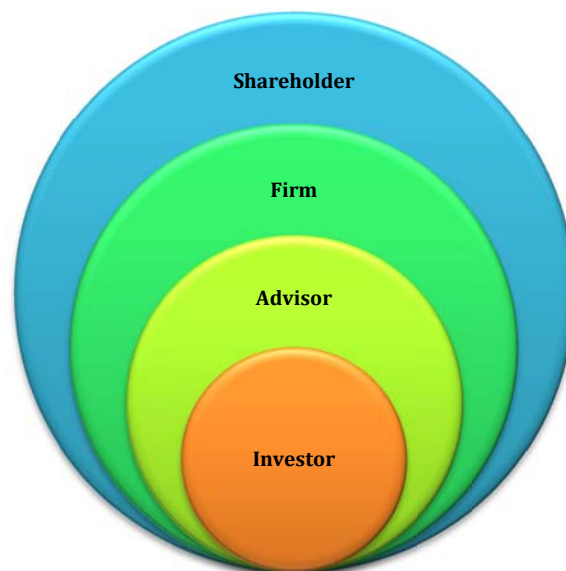
The tactical asset class has seen the most growth in the tactical ETF management space. According to Morningstar, the Tactical ETF Managed portfolio asset class grew by 40% in 2013¹. As a comparison, Morningstar also points out that ETF assets increased 26% in 2013. At RPg, we think the ETF and ETF managed portfolios will continue their strong growth. Additionally, we think an approach similar to how managed futures were utilized will help power and sustain the move to tactical ETF solutions. It has been said that fast moving trends get most of the attention, but slow moving trends have most of the power.

In our opinion, it would not be a bad thing to see more measured, sustainable levels of growth that may mean seeing more participants in the tactical sleeve of investor portfolios. With technology like the Unified Managed Account (UMA) platforms at many financial services firms this can be delivered seamlessly and is a realistic goal.

Investor alignment = success for everyone involved

We think that when the industry aligns their interests with the investor, everyone wins. If a move to include a tactical sleeve in a multi-asset allocation in fact reduces volatility and reduces the risk of loss there is a positive chain reaction throughout the industry. Chart 2 shows the string of beneficiaries who enjoy more stability when focused solely on achieving the goal of a fully funded retirement for an investor.

Chart 2 – Beneficiaries of Investor Alignment



Conclusion

These thought processes bring up several points to consider in building multi-asset portfolios and/or when including a tactical component to an allocation. First is asking the right question about an investor's biggest risks and building out from that point. We think it is essential to start with a needs-based solution focused on minimizing a shortfall of wealth in retirement. This process should have the flexibility to adjust as an investor's needs change and/or asset valuations change. At RPg, we think a tactical approach can provide an objective way of seeking to avoid such a shortfall, and can be highly customizable in a way that seeks to solve the right challenge.

Second, we think employing a tactical approach during the accumulation phase and distribution phase is essential in helping investors stay on their necessary glide path seeking to preserve wealth through retirement. By tapping into a collection of intelligence we think investors will come to better conclusions in their tactical sleeve which in turn should produce better outcomes.

Third, is the alignment of interests. If we define risk in a way that the investor does, and that has an effect of compressing volatility in their portfolios, we think there is a positive chain reaction that begins with a better investment eco-system for the investor.

This includes:

- Lower volatility in their portfolios
- Healthier decision making process around their biggest risk; a shortfall of wealth in retirement,
- Lower volatility of revenue for the advisor, firm, and shareholder.

And it all starts with the investor.

¹ Morningstar ETF Managed Portfolios Landscape Q4 2013

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