

Can a Tactical ETF Strategy be used as a Liquid Alternative?

This blog post doesn't have anything to do with country-focused or factor-based investing, so hopefully you'll stay with me. I recently attended the Investment Management Consultant's Association annual conference in Boston. It was two days of (mostly) strong content, and gave me several ideas for new lines of research. As part of the conference, I had the opportunity to moderate a panel entitled "Liquid Alternatives and Tactical Allocation – Two Sides To The Same Coin?" In the panel discussion, we talked about the rise of tactical asset allocators (also known as ETF strategists, ETF asset managers, ETF model providers, etc.) and how the use of dynamic beta exposure management had increased substantially since 2008. We discussed the different levels of tactical management, including a spectrum of managers who range from Core/Satellite (not a lot of tactical swings) to managers who will go from 100% invested to 100% cash. We also reviewed the current availability of alternative strategies in 40 Act wrappers, discussing the pros and cons of each type of strategy and whether some were more fit than others for transparent, liquid vehicles. As we talked, it occurred to me that at the moment we were missing some good old-fashioned quantitative data on the question.

The idea of this post is to answer a simple question: Can investors use a tactical allocator instead of an "alternative" strategy to benefit the balanced portfolio of a traditional investor? What follows here is NOT an exhaustive review of the subject, and we are well aware of the difficulties in defining and analyzing alternative strategies versus traditional asset classes. We are also aware of the short-term nature of many of the tactical track records (although some are over 10 years at this point) as well as the small universe of tactical managers with a sufficient track record for the analysis.

We looked at data going back to the end of 2006, chose a comparison universe comprised of 3 tactical managers (one or two of which everyone would know), 2 balanced funds (also well-known), 3 traditional asset class benchmarks, and 7 different alternative benchmarks. The names of the tactical managers and funds have been hidden, as the specifics of which managers we are looking at are less relevant. So here is the list.

Tactical	Tactical Manager 1
Tactical	Tactical Manager 2
Tactical	Tactical Manager 3
Balanced	Balanced Fund 1
Balanced	Balanced Fund 2
Alternative	Alternative Fund 1
Alternative Index	Morningstar Broad Hedge Fund TR USD
Alternative Index	Greenwich Global HF
Alternative Index	Credit Suisse Multi-Strategy USD
Alternative Index	Credit Suisse Managed Futures USD
Alternative Index	HFRI FOF: Diversified
Alternative Index	CISDM EW Hedge Fund USD
Alternative Index	Greenwich Global HF Multi-Strategy
Traditional Index	Barclays US Agg Bond TR USD
Traditional Index	MSCI ACWI NR USD
Traditional Index	45% ACWI-45% Barclays Agg-10 % HFRI FOF Conservative

All performance in our analysis is sourced from Morningstar Direct, and covers the time period from 12/31/2006 to 3/31/2014.

Our first look was at the absolute and risk-adjusted performance of the strategies.

Table 1

	Annualized Return	Standard Deviation	Excess Return	Sharpe Ratio (arith)	Downside Deviation	Alpha	Beta	R2
Tactical Manager 1	5.16	11.14	0.67	0.38	3.70	0.62	1.06	74.67
Tactical Manager 2	14.02	17.42	9.53	0.75	7.91	9.49	1.09	32.55
Tactical Manager 3	7.70	12.72	3.20	0.53	3.17	2.26	1.30	86.51
Balanced Fund 1	6.14	11.44	1.64	0.46	2.36	1.00	1.21	92.56
Balanced Fund 2	6.91	13.95	2.42	0.43	4.07	1.13	1.44	88.54
Alternative Fund 1	2.30	8.66	-2.20	0.16	2.24	-1.79	0.90	90.03
Morningstar Broad Hedge Fund TR USD	4.15	5.72	-0.35	0.56	4.19	1.42	0.49	59.93
Greenwich Global HF	4.47	6.48	-0.02	0.55	2.94	1.20	0.63	79.22
Credit Suisse Multi-Strategy USD	5.46	6.46	0.97	0.70	3.85	2.52	0.54	57.17
Credit Suisse Managed Futures USD	1.83	11.04	-2.66	0.08	9.43	1.11	0.10	0.66
HFRI FOF: Diversified	1.47	5.67	-3.03	0.10	4.75	-1.13	0.47	57.48
CISDM EW Hedge Fund USD	4.73	7.56	0.23	0.50	2.74	1.09	0.74	80.24
Greenwich Global HF Multi-Strategy	4.60	5.43	0.10	0.68	3.95	1.96	0.45	58.35
Barclays US Agg Bond TR USD	5.00	3.41	0.51	1.20	5.59	3.62	0.10	7.77
MSCI ACWI NR USD	3.77	18.80	-0.72	0.15	7.43	-3.34	2.03	97.25
45% ACWI-45% Barclays Agg-10 % HFRI FOF Conservative	4.49	9.10	0.00	0.39	0.00	0.00	1.00	100.00

In Table 1, both the tactical and balanced portfolio groups compared favorably to the alternative indexed from a return perspective, but definitely had significantly higher standard deviation than all of the alternatives except for managed futures. Each had positive alpha to the 45/45/10 benchmark, with betas higher than 1. The R2 of the multi-strategy alternatives ranged between 0.57 and 0.79, which was somewhat similar to those of the tactical managers ranging from 0.32 to 0.86. The balanced funds R2 were much higher, on the order of 0.88 to 0.92. In addition, the sharpe ratios of the multi-strat alternative indexes were in the 0.5-0.68 range, which was similar to the range of 0.38 to 0.75 for tactical and balanced managers. At least from this first cut, it looked like the tactical managers were in the same neighborhood as the alternative benchmarks.

Next we looked at the information and capture ratios for the strategies.

Table 2

	Information Ratio (arith)	Tracking Error	Up Period Percent	Down Period Percent	Up Capture Ratio	Down Capture Ratio
Tactical Manager 1	0.12	5.64	57.47	42.53	123.47	126.85
Tactical Manager 2	0.66	14.38	64.37	35.63	168.19	106.24
Tactical Manager 3	0.59	5.43	62.07	37.93	147.79	136.63
Balanced Fund 1	0.45	3.64	62.07	37.93	128.28	124.14
Balanced Fund 2	0.39	6.22	56.32	43.68	154.59	153.76
Alternative Fund 1	-0.76	2.88	59.77	40.23	82.80	97.41
Morningstar Broad Hedge Fund TR USD	-0.06	5.94	64.37	35.63	63.31	50.40
Greenwich Global HF	0.00	4.47	65.52	34.48	74.82	63.87
Credit Suisse Multi-Strategy USD	0.16	5.99	72.41	27.59	68.96	45.40
Credit Suisse Managed Futures USD	-0.19	13.72	52.87	47.13	46.03	48.81
HFRI FOF: Diversified	-0.50	6.09	63.22	36.78	50.29	58.82
CISDM EW Hedge Fund USD	0.06	4.11	65.52	34.48	81.12	70.46
Greenwich Global HF Multi-Strategy	0.02	6.10	67.82	32.18	62.31	44.39
Barclays US Agg Bond TR USD	0.06	8.82	68.97	31.03	23.43	-17.10
MSCI ACWI NR USD	-0.07	9.94	55.17	44.83	189.29	232.39
45% ACWI-45% Barclays Agg-10 % HFRI FOF Conservative		0.00	62.07	37.93	100.00	100.00

In Table 2, all of the tactical and balanced strategies had strong information ratios vs. the benchmark, while the alternatives indexes struggled in that same area. The worst performers were the HFRI FoF: Diversified index, as well as the liquid alternatives fund 1. The Up/Down capture ratios, however, told a different story. In all cases, the tactical and balanced managers had higher up and down capture ratios than the benchmark, while the alternatives indexes all showed up/down capture ratios of 45%-75%. This was not a great surprise given the realized volatility differentials that we saw in Table 1. We decided to continue this line of research by looking at some of the downside statistics in Table 3.

Table 3

	Best Month	Worst Month	Best Quarter	Worst Quarter	Max Drawdown	Max Drawdown # of Periods	Max Drawdown Peak Date	Max Drawdown Valley Date
Tactical Manager 1	8.27	-9.62	13.66	-11.88	-31.83	16.00	11/1/2007	2/28/2009
Tactical Manager 2	21.32	-11.08	28.19	-8.56	-20.84	17.00	6/1/2007	10/31/2008
Tactical Manager 3	9.23	-11.44	13.68	-12.04	-30.37	16.00	11/1/2007	2/28/2009
Balanced Fund 1	8.48	-10.54	12.15	-12.13	-29.37	9.00	6/1/2008	2/28/2009
Balanced Fund 2	10.20	-10.80	14.35	-15.29	-33.12	16.00	11/1/2007	2/28/2009
Alternative Fund 1	7.60	-10.94	12.16	-10.35	-27.18	9.00	6/1/2008	2/28/2009
Morningstar Broad Hedge Fund TR USD	3.92	-5.54	6.57	-9.49	-17.06	14.00	11/1/2007	12/31/2008
Greenwich Global HF	5.08	-6.01	8.81	-9.08	-17.76	16.00	11/1/2007	2/28/2009
Credit Suisse Multi-Strategy USD	4.28	-7.35	8.34	-12.59	-24.72	14.00	11/1/2007	12/31/2008
Credit Suisse Managed Futures USD	6.61	-5.42	12.67	-7.11	-17.42	29.00	5/1/2011	9/30/2013
HFRI FOF: Diversified	3.07	-6.53	4.42	-10.23	-21.75	14.00	11/1/2007	12/31/2008
CISDM EW Hedge Fund USD	6.23	-7.90	11.83	-9.71	-21.71	16.00	11/1/2007	2/28/2009
Greenwich Global HF Multi-Strategy	4.19	-5.77	6.41	-8.62	-13.65	6.00	6/1/2008	11/30/2008
Barclays US Agg Bond TR USD	3.73	-2.36	4.58	-2.32	-3.83	7.00	4/1/2008	10/31/2008
MSCI ACWI NR USD	11.80	-19.82	22.26	-22.37	-54.92	16.00	11/1/2007	2/28/2009
45% ACWI-45% Barclays Agg-10 % HFRI FOF Conservative	5.60	-10.57	11.02	-9.53	-28.89	16.00	11/1/2007	2/28/2009

The theme of higher downside risk and drawdowns continued in our analysis of Table 3. The worst month for the tactical and balanced managers was similar to that of the benchmark, but higher than any of the alternative indexes. The differential was less when looking at the worst quarter, but still was slightly higher for tactical and balanced managers. The max drawdown was similar in magnitude for all of the indexes and managers, and the max drawdown valley date for all of the investments was within 3 months of each other (with the exception of managed futures that has a 9/30/13 date – but that is a subject for another blog post).

Up to this point, we had seen that tactical managers are generally more volatile than both the benchmark as well as the alternative universe. This might imply that they in fact, are not good substitutes for more traditional alternatives investments. However, the astute reader will rightly recognize that no analysis of the contribution of an investment to the overall portfolio is complete without a correlation analysis. Tables 4-6 include a correlation analysis of 3 time periods: Table 4 analyzes the time period from 12/06 – 3/09, Table 5 the time period from 3/09 to 3/14, and Table 6 the entire time period from 12/06-3/14. The reason for breaking up the time periods is to see how the strategies performed in both up and down trending markets.

Table 4 – Correlations from 12/06 – 3/09

Investment	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1 Tactical Manager 1	1.00															
2 Tactical Manager 2	0.76	1.00														
3 Tactical Manager 3	0.90	0.62	1.00													
4 Balanced Fund 1	0.78	0.49	0.91	1.00												
5 Balanced Fund 2	0.81	0.48	0.91	0.95	1.00											
6 Alternative Fund 1	0.76	0.58	0.83	0.93	0.86	1.00										
7 Morningstar Broad Hedge Fund TR USD	0.72	0.55	0.76	0.80	0.72	0.83	1.00									
8 Greenwich Global HF	0.82	0.56	0.89	0.94	0.89	0.92	0.89	1.00								
9 Credit Suisse Multi-Strategy USD	0.73	0.47	0.82	0.87	0.85	0.87	0.80	0.93	1.00							
10 Credit Suisse Managed Futures USD	0.31	0.28	0.25	0.31	0.23	0.38	0.67	0.39	0.26	1.00						
11 HFRI FOF: Diversified	0.77	0.49	0.83	0.86	0.82	0.83	0.89	0.95	0.91	0.47	1.00					
12 CISDM EW Hedge Fund USD	0.78	0.55	0.85	0.91	0.85	0.91	0.83	0.97	0.90	0.28	0.88	1.00				
13 Greenwich Global HF Multi-Strategy	0.74	0.50	0.79	0.88	0.82	0.89	0.90	0.96	0.92	0.47	0.94	0.92	1.00			
14 Barclays US Agg Bond TR USD	-0.20	-0.06	-0.18	-0.06	-0.09	0.08	0.11	-0.08	-0.01	0.33	-0.13	-0.10	0.05	1.00		
15 MSCI ACWI NR USD	0.86	0.58	0.94	0.96	0.97	0.91	0.75	0.92	0.86	0.22	0.82	0.90	0.84	-0.12	1.00	
16 45% ACWI-45% Barclays Agg-10 % HFRI FOF Conserva	0.83	0.57	0.92	0.96	0.96	0.93	0.78	0.92	0.87	0.29	0.82	0.89	0.86	0.05	0.99	1.00

Table 5 – Correlations from 4/09 – 3/14

Investment	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1 Tactical Manager 1	1.00															
2 Tactical Manager 2	0.47	1.00														
3 Tactical Manager 3	0.87	0.38	1.00													
4 Balanced Fund 1	0.74	0.23	0.90	1.00												
5 Balanced Fund 2	0.77	0.13	0.89	0.97	1.00											
6 Alternative Fund 1	0.71	0.25	0.80	0.92	0.90	1.00										
7 Morningstar Broad Hedge Fund TR USD	0.64	0.46	0.70	0.70	0.63	0.77	1.00									
8 Greenwich Global HF	0.80	0.28	0.89	0.93	0.91	0.91	0.82	1.00								
9 Credit Suisse Multi-Strategy USD	0.74	0.18	0.81	0.88	0.87	0.87	0.73	0.95	1.00							
10 Credit Suisse Managed Futures USD	0.22	0.49	0.14	0.15	0.08	0.39	0.70	0.31	0.24	1.00						
11 HFRI FOF: Diversified	0.81	0.37	0.84	0.83	0.80	0.84	0.85	0.95	0.92	0.41	1.00					
12 CISDM EW Hedge Fund USD	0.74	0.18	0.86	0.93	0.91	0.87	0.75	0.96	0.91	0.20	0.89	1.00				
13 Greenwich Global HF Multi-Strategy	0.78	0.32	0.80	0.85	0.83	0.87	0.84	0.97	0.94	0.42	0.94	0.92	1.00			
14 Barclays US Agg Bond TR USD	-0.25	0.01	-0.25	-0.10	-0.10	0.07	0.18	-0.09	-0.03	0.48	-0.12	-0.18	0.03	1.00		
15 MSCI ACWI NR USD	0.81	0.21	0.92	0.98	0.99	0.89	0.64	0.92	0.87	0.10	0.81	0.91	0.84	-0.14	1.00	
16 45% ACWI-45% Barclays Agg-10 % HFRI FOF Conserva	0.77	0.21	0.89	0.97	0.98	0.92	0.69	0.92	0.88	0.20	0.81	0.89	0.86	0.05	0.98	1.00

Table 6 – Correlations from 12/06 – 3/14

Investment	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1 Tactical Manager 1	1.00															
2 Tactical Manager 2	0.71	1.00														
3 Tactical Manager 3	0.90	0.59	1.00													
4 Balanced Fund 1	0.83	0.52	0.92	1.00												
5 Balanced Fund 2	0.84	0.52	0.92	0.94	1.00											
6 Alternative Fund 1	0.81	0.52	0.88	0.94	0.86	1.00										
7 Morningstar Broad Hedge Fund TR USD	0.70	0.43	0.75	0.78	0.72	0.79	1.00									
8 Greenwich Global HF	0.80	0.48	0.86	0.90	0.86	0.88	0.93	1.00								
9 Credit Suisse Multi-Strategy USD	0.67	0.27	0.74	0.74	0.73	0.76	0.87	0.88	1.00							
10 Credit Suisse Managed Futures USD	0.15	0.18	0.10	0.18	0.10	0.14	0.42	0.25	0.09	1.00						
11 HFRI FOF: Diversified	0.70	0.34	0.74	0.76	0.73	0.75	0.94	0.94	0.94	0.24	1.00					
12 CISDM EW Hedge Fund USD	0.79	0.48	0.86	0.90	0.86	0.89	0.90	0.98	0.87	0.14	0.90	1.00				
13 Greenwich Global HF Multi-Strategy	0.68	0.38	0.73	0.78	0.74	0.77	0.93	0.94	0.90	0.34	0.95	0.91	1.00			
14 Barclays US Agg Bond TR USD	0.01	0.12	0.09	0.20	0.10	0.30	0.11	0.06	0.01	0.14	-0.03	0.07	0.08	1.00		
15 MSCI ACWI NR USD	0.89	0.57	0.94	0.96	0.96	0.93	0.76	0.89	0.75	0.05	0.76	0.90	0.75	0.11	1.00	
16 45% ACWI-45% Barclays Agg-10 % HFRI FOF Conserva	0.86	0.57	0.93	0.96	0.94	0.95	0.77	0.89	0.75	0.08	0.75	0.89	0.76	0.27	0.99	1.00

Since there are so many numbers on these charts, it is important to note that the alternative universe includes investments #7 through #13. As we look at the correlations on Table 4, it is not a great surprise to see that most of the assets are correlated to the benchmark, and to each other. This makes sense in the context of the high inter-asset correlations that were commonplace in 2007 and 2008 during the crisis. The notable exceptions are tactical

manager 2, managed futures, and bonds. Table 5, surprisingly, tells a similar story. So we moved on to Table 6 to see if we could draw some conclusions. It is clear from the tables that the investments with the lowest correlation to the 45/45/10 benchmark, and the rest of the universe are tactical manager 2, managed futures, and bonds. The alternatives universe (ex-managed futures) had correlations to the benchmark of between 0.75 and 0.89. Frankly, those aren't great numbers in a portfolio construction sense. The balanced funds had correlations of 0.94 and 0.96, which essentially are the same as the benchmark. The tactical managers ranged between 0.57 and 0.93 correlations.

So what is the bottom line on all of this? How do tactical managers stack up to alternatives? Are they a viable element in portfolio construction? When compared to alternative benchmarks, we noted that tactical managers have the following characteristics:

- Higher average returns with higher volatility
- Similar downside characteristics
- Similar correlation characteristics

Can tactical managers perform the same function as some alternative strategies? I believe they can. As always, the trick is to figure out how to best use them in a client portfolio. Allocating a portion of the client's "alternative" investments to tactical managers may be a good place to start.

About Accuvest

Accuvest Global Advisors (AGA) is a registered investment advisor with the SEC and is based out of Walnut Creek, CA. AGA serves a diverse, global client base of individuals, institutions, and investment companies. Founded in 2005, AGA has drawn considerable recognition in the industry for their work in building global strategies through the use of single-country ETFs. They run a proprietary country ranking model used to assess the relative attractiveness of developed and emerging countries. The investment team from AGA has been awarded for their research in the value of country selection and can be seen speaking at a variety of industry events as well as mainstream print and media outlets.

Disclosures

This brochure is strictly informational and should be used for research use only. This brochure should not be construed as advertising material. The opinions expressed are not intended to provide investing or other advice or guidance with respect to the matters addressed in this brochure. All relevant facts, including individual circumstances, need to be considered by the reader to arrive at investment conclusions to comply with matters addressed in this brochure. Charts and information are sourced from Accuvest Global Advisors and the MSCI, unless otherwise noted. Remember that investing involves risks, as the value of your investment will fluctuate over time and you may gain or lose money. You should seek advice from your financial adviser before making investment decisions. Investment risks are borne solely by the investor and not by AGA. AGA is an independent investment advisor registered with the SEC. All disclosures, marketing brochures, and supplemental firm sheets are available upon request.