Clarifying our investment rationale regarding tactical versus strategic investing

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Our clients understand and appreciate that we use Modern Portfolio Theory (also known as mean-variance optimization) in the methodology used to construct their asset allocation.

Return targets are first derived through a financial planning exercise, which determines the average rate of return necessary to achieve stated financial goals. Optimization software then calculates asset class weightings in a way designed to deliver the desired rate of return with an acceptable amount of variability. Periodic rebalancing keeps the portfolio in an appropriate risk/reward zone.

A strategic asset allocation changes very slowly and is designed for investors with long-term orientations.

Implicit in a strategic approach is the belief that any asset classes that outperform or underperform in the short term will tend to gravitate back to their long-term average returns through a process known as mean reversion. This faith permits the long-term investor varying degrees of freedom from the twin shackles of uncertainty and indecision caused by short-term volatility.

While we believe the principles underlying a strategic asset allocation are the most certain way of helping our clients to pursue their long-term financial goals, there can be challenges associated with arriving at or maintaining a fully invested state.

The most common challenge to maintaining a fully invested state is a liquidity event. Liquidity events come in many shapes and sizes and may include the sale of real estate or a family business, the sale of concentrated stock or options, court judgments, insurance settlements or an inheritance.

Depending on when they occur, liquidity events may interrupt the process of maintaining a fully invested state of strategic allocation. In some cases, the size of the liquidity event may dwarf the underlying invested capital base. Such events are usually pleasantly disruptive. However, the increased responsibility and corresponding uncertainty can lead to unexpected feelings of anxiety.

There may also be other reasons arguing against allocating newly found capital in one large block. Fortunately, we have tools at our disposal to help. Dollar cost averaging is a simple but powerful, time-tested method for easing into a long-term investment orientation in a way that can help mitigate the effects of short-term volatility.

In an interest rate environment where attractive real rates of return can be achieved for assuming a reasonable level of credit or interest rate risk, dollar cost averaging over short

to intermediate periods can occur efficiently, at a potentially low opportunity cost. This is because capital waiting to be allocated strategically earns a competitive return in safe, liquid instruments while sidelined.

In a low real interest rate environment, however, dollar cost averaging becomes less efficient. Safe, liquid instruments may not yield a positive return net of inflation and/or taxes. This can cause an erosion of purchasing power through the simple act of waiting.

To complicate matters, credit risk may be more difficult to ascertain in a low rate environment. The direction and timing of interest rate movements may be unclear. In order to address the heightened uncertainty, the dollar cost averaging period may lengthen, which can create an increase in anxiety and indecision.

A tactical orientation can be handy during periods like this. A tactical investment is intended to bridge the gap between the liquidity event and full commitment to the strategic allocation, an intermediate step along the continuum between the two ends.

Tactical investing makes use of judgments about tradeoffs between risk and reward within the context of the current economic climate and seeks to identify and capture (or hedge) mispricings, directionality or both, utilizing a shorter time horizon.

For example, an investor who fears a falling dollar may choose to hold an equal measure of U.S. government debt and sovereign debt of another developed country. In this way, the investor gets similar safety of principal, but has reduced the effects on the purchasing power between movements of the U.S. dollar relative to the other country's currency.

Other investors who fear eventual inflation but are uncertain about the timing of an interest rate increase might choose floating rate notes or bank loan funds as an alternative to longer-dated fixed rate corporate bonds. Rates adjust periodically based on a reference rate (typically LIBOR or the federal funds rate) plus a spread. Bank loans are collateralized and are senior debt, with the bank having first claim on assets in the event of a default.

These are just two examples of tactical approaches that can help bridge the gap between low risk, low return "cash" investments and a longer term, higher return, higher risk strategic allocation.

It should be understood that tactical investing is designed to complement a strategic asset allocation policy, not replace it. In the meantime, investors can benefit from having additional choices between either being sidelined or "all in" while they wait for greater clarity during uncertain economic times.

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