This document is intended for investment professionals and eligible counterparties only.

TAA-les Of Error

Exploring the Human Factor in Tactical Asset Allocation

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Introduction

Tactical asset allocation (*hereafter quasi-unaffectionately referred to as TAA*) remains as prevalent as it is fallible.

It's easy to see the allure. Under pressure to justify selection, many a money manager decides the best way to showcase their skill is by making significant tactical calls to capture a sliver of basis point bliss, and the hearts and minds of their *adoring* fans.

And there's nothing wrong with trying to outperform for your investors; but everything wrong with it if your chosen medium is demonstrably (and perhaps fundamentally?) flawed.

The reality is that to win at TAA, too many variables which are out of your control must come together at the same time.

We'd like to delve into why that's nigh on impossible to do *consistently* in a human-led investment process. And that specificity is important to note. Our context here is that TAA is generally flawed when it is; human-**driven**, **short-term in nature**, **seeking upside capture** rather than capital preservation and **driven by bigger predictive 'calls'**.

AQ Says...

Tactical asset allocation by humans results in inconsistent outperformance.

Not that outperformance is impossible under TAA, not that everyone else is wrong and we are right (OK, maybe a sprinkling of that...but a respectful and reverent sprinkling!), but that it will give you inconsistency and uncertainty.

For us, a crucial aspect in getting value from any multi-asset solution and, indeed any retail investment, is consistency.

1. The Illusion (Delusion?) of TAA

This breaks down into three concepts;

- **Humans predicting short-term market movements leads to consistent alpha over the longer term.**

The chief mistake. It's simply statistically untrue. Not on average across the history of retail or self-directed investing.

The concept, the idea, is understandably evocative. But in reality, the results say different, with active managers the world over failing to beat benchmarks over meaningful timeframes. Yes, this sweeps together a multitude of investment approaches, but tactical calls run through the

MOs of many a portfolio manager to this day and the results are *not* consistent alpha outside of singular trend-bucking examples.

- Executing timely shifts

A, frankly, Herculean task. To get to within a couple of percent of any turning point based on human intuition and casual deployment of technical analysis could be considered exceptional. We did toy with the idea of comparing executing timely shifts in asset allocation as akin to trying to catch a falling knife in a hurricane. In reality, this isn't a great idiom as it risks overstating the overlap between TAA and market timing. Yes, time is a factor when being tactical but those two just aren't the same.

That said, humans tactically timing markets is perennially flawed.

- The domino effect of bad TAA

Compounding works both ways, alas.

A manager makes a call, it backfires, which dominoes straight into chasing the loss trying to remedy the error. The twist? Mr or Mrs Manager seeks to rectify the issue using the same flawed strategy as created it.

The only thing that compounds is the relative underperformance.

AQ Says...

Asset allocation is best derived from aggregating 'best in class' performers at any one time, adjusting for risk. Instantly this removes the pitfalls of:

- Focusing on one single manager style.
- Making emotional tactical calls.

Consequently, we're strategic, and we tilt based on shorter term consensus among the best; we don't sit and discuss macro trends and potential market events in order to outwit them.

Our portfolios have a passive base, with quant-screened active allocations when appropriate. We're no naysayers of active management but it must be controlled and algorithmically prompted.

2. The Human Element:

It's quite impossible to separate any of the points within this piece from human fallibility when you *really* break each one down, but the biases we're all prone to warrant special mention.

Behavioural biases in TAA

A study we would love to see is *Psych 101: Inside the Minds of Fund Managers During Market Turbulence.* Where emotion reigns supreme, and logic takes a back seat.

The actions taken are of course, intrinsically linked with your style. The contrarian manager sees potential value at every turn, and their team undertakes research in that context. Thus, they confirm that there is value everywhere! Where there is no robust, emotionless research and selection process, the probability of bad outcomes is often neglected.

Managerial narrative is also key. How could a star fund manager not want that stardom to continue? Try and make a balanced decision when you believe that everything you touch turns to gold...

AQ Says...

We believe the most rational thing a professional investor, or any investor for that matter, can do is accept that they're not.

This is not a slur.

It's simply an observation backed up by 250 years of empirical study and over 2000 years of human history that as the sensible, rational prefrontal cortex gets fired up to make an investment call in a market downturn, the limbic system sweeps in with the baseless confidence of a university fresher after pint 6.

Best-in-class asset allocation policy, a continuum that sees us only ever placed as neutral (relative to outperforming peer group sample) and defensive, and a minority of active funds selected only algorithmically gives us almost complete mitigation of bias and a human decision-making framework of yes/no.

3. Black Swans & Dynamic Markets:

Vulnerability to Black Swan Events

TAA relies on making two extraordinarily difficult calls:

1. Predicting a future event.
2. Predicting exactly how markets will react to that event.

So, equity managers incredibly 'gifted' enough to predict the pandemic might well have gone to cash early in Q1 2020. Unless they reversed that decision sharply following the initial sell-off, they would have been left significantly behind those who held, as a raft of macro measures swept through markets and left global equities ahead of cash for the full year.

And that's another point.

You don't just have to make those two fortuitous calls once, but twice – once again on the way out of the trade.

Michael Burry called the housing crash in 2008, though, right?

Yes, and they made a film about it. They haven't (yet) made a film about the residual 99.50% of investment history.

Inflexibility in Dynamic Markets

Human-made TAA struggles to adapt to dynamic market conditions, and if we know anything by now, it's that markets are *dynamic*.

Trials and tribulations associated with actually predicting an event or calling a turning point and then predicting the market reaction aside, it's difficult to move with sufficient pace to capitalise.

Generally (but not exclusively), the larger the portfolio, the institution, or both, the harder it is to position quickly, although this isn't an issue for Big Investment Business only. Decision-making takes time, especially if consensus is required. Throw in any dealing and liquidity constraints, and the element of proportionate response-time is lost.

AQ Says...

Imagine a hastily arranged investment quorum. A CIO adamant that "this is Lehman mark II". Furious arguments amongst analysts and a hung jury, so we come back tomorrow with more (confirmation bias-addled) data to decide for good and all.

These are all examples of things that never happen at 8AM HQ.

AQ is responsive, easily deployable, built to react to dynamic markets and to do so without bias, superstition, or sentimentality.

To tie things together neatly, we believe that human tactical calls will always produce inconsistent performance. There are clear and simple ways to mitigate it without simply accepting you live and die by the index, and we have worked hard to imbue that into our methodology.

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