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Using Tactical Investment Strategies in a Passive Investing Environment

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Passive vs. Active Investing

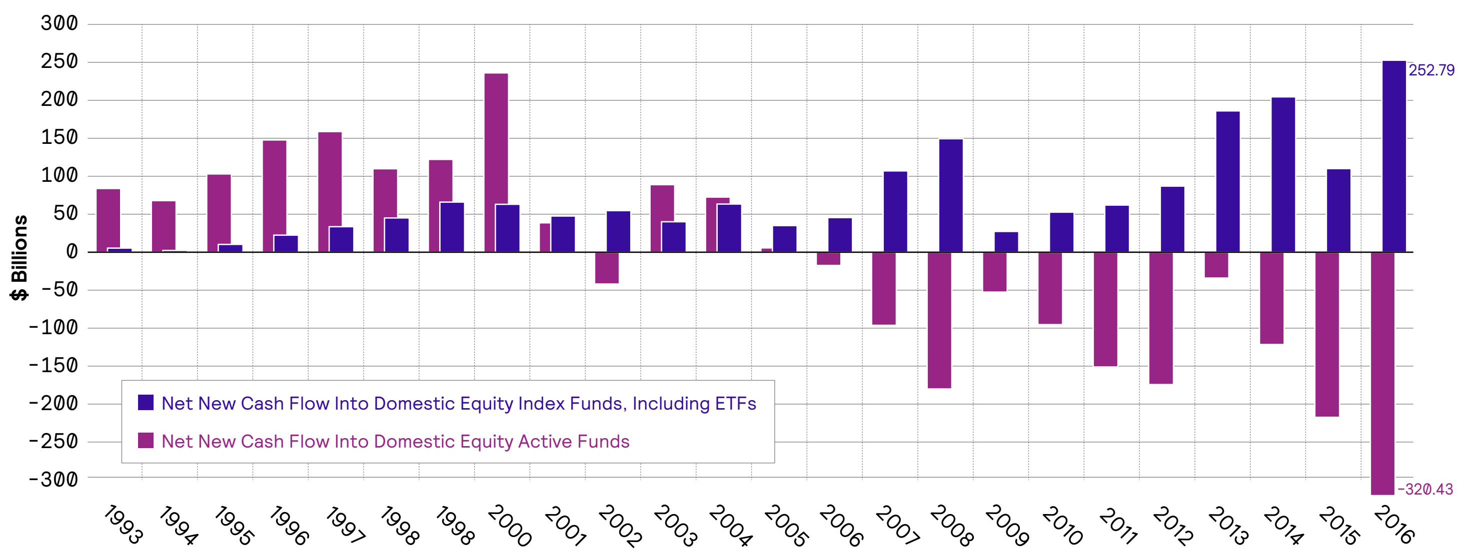
The rush to passive investing has accelerated in recent years. In 2016, there was a record net new cash inflow in domestic equity index funds (including ETFs) of over $250 billion. At the same time, there was a record net outflow in domestic equity active funds of over $300 billion. Many market participants have asked if this is the new model for investment management. *Figure 1* seems to suggest that this trend is secular in nature, having persisted for 25 years, rather than merely a cyclical phenomenon. It leaves many wondering: why should an investor hire an active manager if active management returns have not exceeded that of unmanaged market indices? Is active management dead?

> "The essence of portfolio management is the management of risks, not the management of returns." —**Benjamin Graham**

FIGURE 1

Record Flows Into Passive Funds and Out of Active Funds

Yearly Data, December 31, 1993 – December 31, 2016



Sources: Ned Davis Research, Investment Company Institute, as of 12/31/16

At the current point in the economic and stock market cycle, with the U.S. stock market having shown continuous positive returns for every year since 2009, it is prudent to ask at what point the market will undergo the type of correction to the uptrend that typically occurs after economic expansions. This question is particularly important for those investors whose time horizon is less than 10 years. Remember that if your investment portfolio declines 50%, as it did during the last recession, you must double your money just to get even. Which begs the question: does the investor's portfolio have sufficient time to recover?

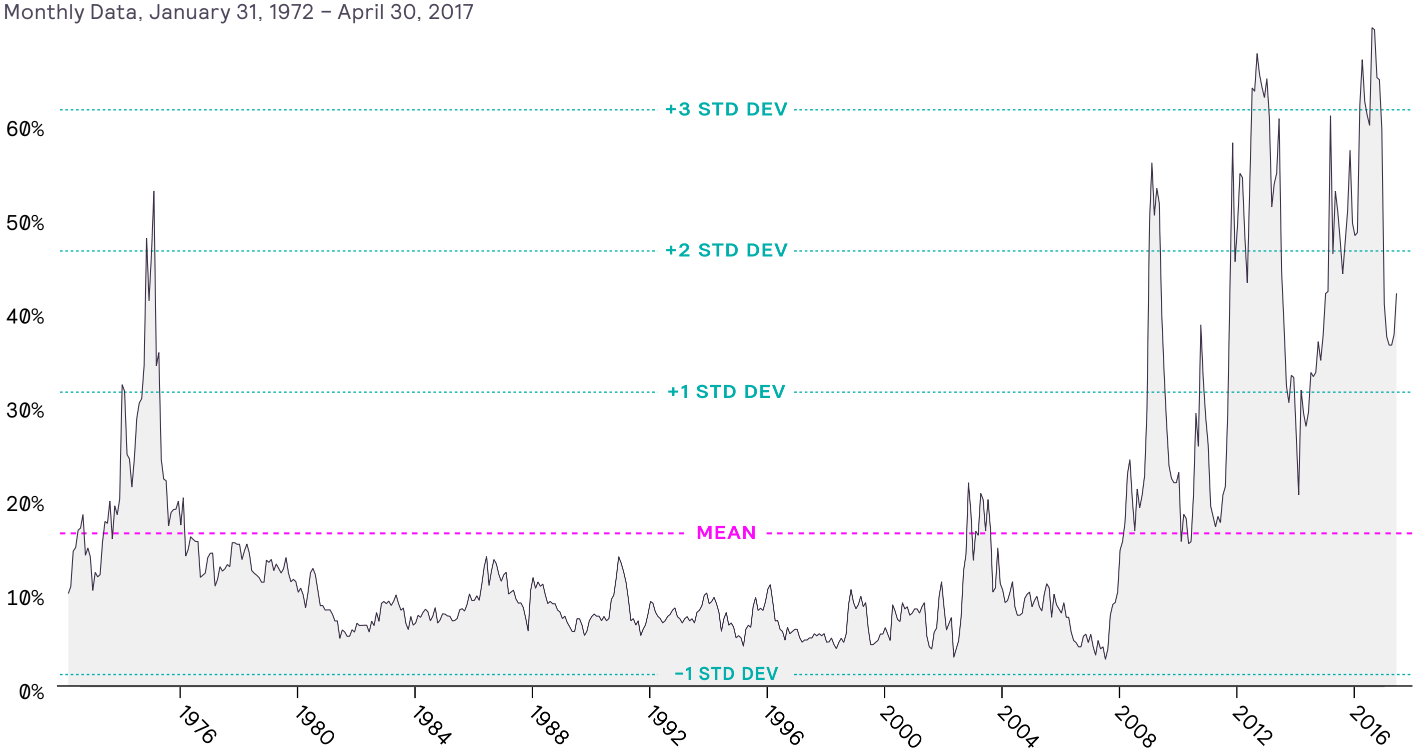
Another consideration when looking at passive vs. active investing is that the stock market advance since 2009 has lifted all boats. High-quality and low-quality securities alike have been buoyed upward by the rising stock market tide. Active investment managers that discern quality from lesser quality securities have been at a disadvantage because the stock market has not rewarded this distinction.

Further, the Federal Reserve's (Fed) monetary policy over the last eight years has kept interest rates low and created an environment where stocks are far more attractive than bonds. In 2016, over 60% of the stocks in the S&P 500 Index had a higher yield than the 10-year U.S. Treasury note *(Figure 2)*, providing a decided advantage for stocks over the fixed-income sector.

FIGURE 2

Percentage of S&P 500 Index Stocks With Higher Yields Than the 10-Year U.S. Treasury Note

Monthly Data, January 31, 1972 – April 30, 2017



Source: Ned Davis Research, as of 04/30/17. Based on indicated annual dividends. Past performance does not guarantee future results.

The Investment Climate Has Changed

In the last two years, the Fed reversed course and has begun to tighten monetary policy. The Fed will likely continue to be less accommodative over the next few years by gradually raising interest rates, reducing their balance sheet, or a combination of both.

One recent result of these actions is that this tightening process has already cut in half the percentage of S&P 500 stocks with yields above the 10-year Treasury note *(Figure 2)*. We would expect this trend to continue, reducing the advantage that stocks have had over bonds. This shift will have major implications for the capital markets as the largest financial institutions reallocate among stocks, bonds and cash. Stock market valuations are also elevated by any measure. The median price-earnings ratio (P/E) on the S&P 500 is at its highest level in over a decade, even higher now than it was prior to the 2008-2009 financial crisis.

> "The four most dangerous words in investing are: *This time it's different.*"
>
> **— Sir John Templeton**

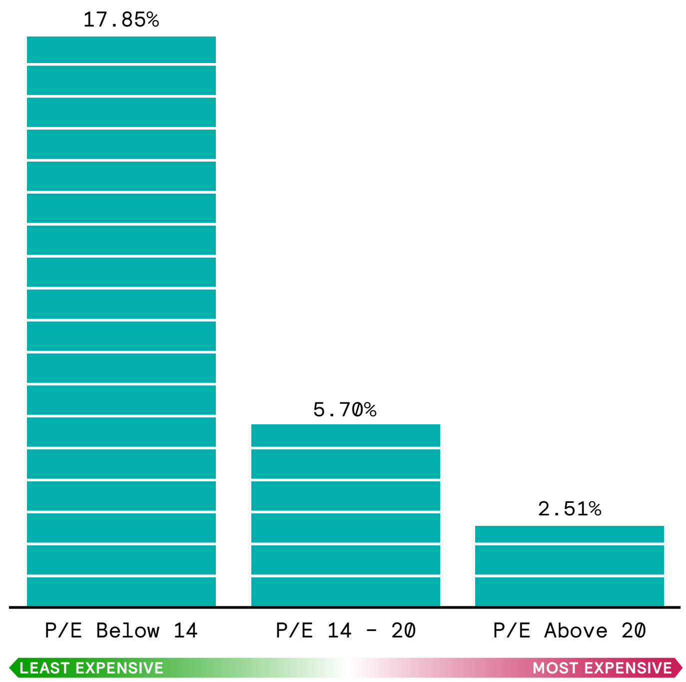
When examining historical stock performance based on P/E levels, the current outlook is not promising. *Figure 3* shows S&P 500 Index levels of P/E broken down into three categories and the subsequent annual returns. As demonstrated, the more expensive the P/E, the worse the return. The S&P 500's current P/E is 23.8, placing it in the most expensive historical category with an annual return of only 2.51%. This environment is decidedly unfavorable for passive investing.

FIGURE 3

Historically, a Higher P/E Has Produced Lower Subsequent Returns

S&P 500 Index Gain/Annum (P/E as of 04/30/17 = 23.8)

December 31, 1935 – March 31, 2017



Sources: Ned Davis Research and S&P Dow Jones Indices, as of 03/31/17
Past performance does not guarantee future results.

During 2004–2007, no one thought real estate prices could fall. In the late 1990s, the financial press spoke of a "new paradigm"—the dot.com era. In 1987, the buzzwords were "program trading and portfolio insurance." In the early 1970s, the accepted investment wisdom was to buy the highest quality growth stocks ("The Nifty Fifty") and hold them forever. And in 1929, Yale economist Irving Fisher proclaimed in the *New York Times that* "stock prices have reached what looks like a permanently high plateau" days before the Crash.

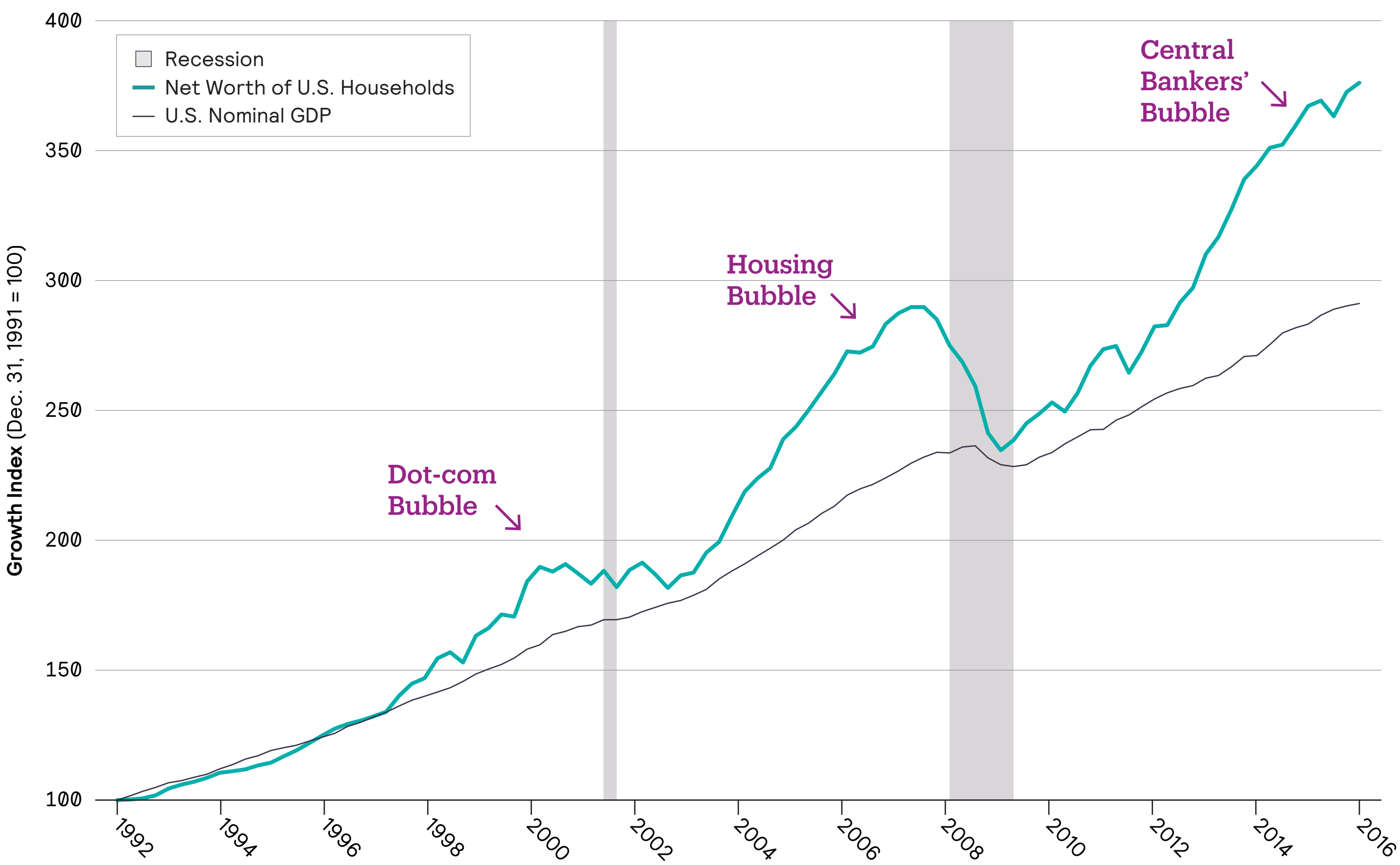
In each of these instances, stock prices subsequently dropped significantly—in some cases, by 50% or more.

During past years, investors have lived in the Golden Age of the Central Banker, as Dr. Ben Hunt, chief investment strategist at Salient, has termed it. Investors were not worried because the Fed and global central bankers always provided enough liquidity to keep the markets from significant declines. In Mario Draghi's famous words, they were committed to do "whatever it takes." Though some may still believe we are living in the Golden Age, the world has now devolved so that investors can no longer necessarily rely on central bank policy.

Figure 4 shows the current situation with respect to asset prices vs. gross domestic product (GDP) in the U.S. Asset prices are as stretched as they have ever been as compared with the rate of growth of GDP.

FIGURE 4

Asset Prices Versus GDP



Source: Bloomberg LP and TCW, as of 12/31/16. For illustrative purposes only. Past performance does not guarantee future results.

As investment advisors on behalf of our clients, we are supportive of lower fees for gaining exposure to asset classes and market segments for the purpose of diversification, particularly in a low interest rate environment. We believe that tilting portfolios toward various fundamental metrics can add significant value. We further believe that this move toward lower fees and a greater use of market index securities is a secular trend that is likely to continue. Indeed, our team's securities investments concentrate largely in only the most liquid equity market indices.

The central problem with passive investing is that it does not offer a method of managing systemic risk. Passive investing provides a method of diversifying portfolios among various asset classes, which can be effective in reducing non-systemic risk, but offers no way of addressing the risk of a more general stock market decline or global financial crisis.

During major stock market declines, all correlations go to 1.00; everything declines. Some well-diversified passive portfolios may decline less, but not in any significant way. Telling your client in 2009 that his or her portfolio was down "only" 40% versus a 50% decline the general market is of little comfort. Yet a significant drop right along with the market is what will happen if investments are limited to passive market indices only. Remember also that many passive investments actually have a higher beta than the general market, so an investor could lose significantly more than the general market depending upon the choice of the particular passive index.

Investors who experienced the last financial crisis do not want to be subject to those types of risks again. They want to make sure that their financial advisor has a plan for dealing with the next crisis. What is the 65-year-old anticipating retirement to do if the market declines 50%, as it did in 2008-2009? What is the pension fund, foundation or endowment to do if returns in the next decade average only 2.5% and there is a major decline in their portfolio value?

That is a perfect storm with no safe harbor in a fully invested passive portfolio.

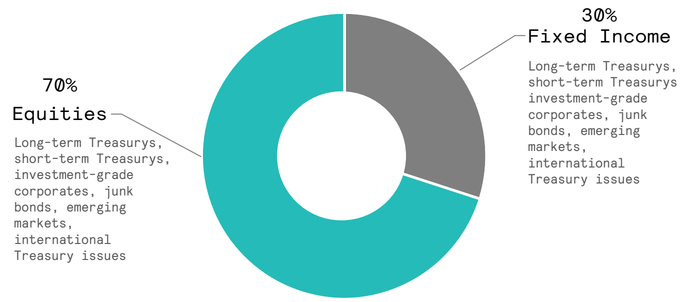
How Tactical Strategies Can Enhance Portfolio Allocation

While no one has a crystal ball into the future, we believe that the following questions should be addressed by those investors who cannot sustain a large loss, however temporary, in their portfolios. In our opinion, these concerns cannot be resolved by passive investing and lower fees. A lower investment fee will pale in comparison with the potential loss that could occur in market value during the next recession and stock market decline, to say nothing of the geopolitical risks or "black swan" events that could occur.

Tactical strategies, on the other hand, offer the investor a method of risk control that may 1) cushion the impact of severe stock market declines, and 2) offer the potential for true noncorrelation by providing potential positive returns during these periods. These strategies can assure clients that there is a manager with a time-tested discipline that can help preserve capital in case of a severe stock market decline. Tactical strategies offer financial advisors a plan for their clients. Perhaps most importantly, tactical strategies provide clients with the confidence and comfort that the manager can and will act immediately to move to help protect the portfolio during turbulent times.

Implementing a Tactical Approach Into a Passive Asset Allocation

In times of lower risk in the market, investors may increase their allocation to equities from a traditional 60/40 portfolio to potentially capture higher returns. Consider a hypothetical portfolio allocation that is 70% equities and 30% fixed income established through the use of ETFs.:



Two data sets that many investors analyze to strategically optimize asset allocation to the individual sectors include:

1. Long-term historical returns and standard deviations for each sector
2. Forward-looking performance estimates and estimated future standard deviations for each sector

If we believe that future returns of stocks or bonds may be below their historical averages and that the market may be subject to a normal correction of 20% or more within the next year or two, we would argue that using either of the two strategic approaches would not be sufficient to protect the portfolio in any significant way. Strategic reallocation through optimization would simply mean that you would lose less.

The approach that we favor would be to reduce the 70% equity allocation to 40% and reallocate the remaining 30% to a tactical manager with a history of capturing a portion of long-term upside equity returns and, most importantly, who was either relatively flat or up in the bear markets of 2002 and 2008. If interest rates were to increase and there was fear of higher short- and long-term rates, we would take the additional step of reducing the 30% fixed-income allocation to 20% and reallocating the remaining 10% to a tactical manager with a proven track record during periods of rising interest rates.

We therefore believe that a 30%-40% allocation to tactical strategies is appropriate in view of high equity valuations accompanied by a tightening of monetary and credit conditions.

Evaluating Potential Tactical Strategies

Evaluating tactical strategies is not easy. Financial advisors and their clients should conduct a thorough analysis prior to investing, which should include the following:

1. How did the manager perform during the bear market periods of 2008-2009 and, if available, 2001-2003? (Any back-tested performance returns must be discounted in this analysis.)
2. Did the manager exceed its own stated goals and benchmarks during this time?
3. How did the manager perform compared to other managers in the tactical or appropriate alternative investment category?
4. Is the same investment team in place that provided the past history of performance?
5. How liquid is the portfolio in case of internal or external shocks to the capital markets?
6. How scalable is the strategy in cases of significant changes in assets? How would a large increase or decrease in assets affect the ability of the manager to execute their strategy?
7. How often are the manager's models updated? Would the mandate prevent the manager from taking immediate action if the models are updated infrequently?
8. What is the manager's risk management discipline and how repeatable is this process? What is the manager's worst month and worst drawdown?

If well-selected with the proper care and due diligence, tactical investment strategies may offer a powerful way to insulate portfolio losses and provide noncorrelated investment returns.

It is true that tactical strategies, and many alternative and hedge fund strategies, have been out of favor for the last five years. Most of these strategies have not kept pace with the S&P 500. However, Warren Buffet said it best:

> "I will tell you how to become rich. Close the doors. Be fearful when others are greedy. Be greedy when others are fearful." — **Warren Buffet**

Significant stock market declines do happen. The time to invest in these strategies is exactly when you don't think you need them and when no one wants them.

About the Author

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Ricardo Cortez is the co-chief executive officer of Broadmark Asset Management. He is responsible for the management of Broadmark's day-to-day business activities as well as the oversight of the firm's sales and marketing efforts. Additionally, he is a member of the investment team and serves as the firm's chief risk officer.

Ricardo joined Broadmark in 2009 as president, global distribution and was named co-CEO in 2013. Prior to Broadmark, he was president of the private client group at Torrey Associates, LLC. He has held roles including vice president at Goldman Sachs as a product manager for the firm's global multi-manager strategies program, and senior vice president at Prudential Investments overseeing product development and sales for the investment management services division.

Ricardo graduated cum laude from Queens College, City University of New York with a bachelor of arts and formerly served as chairman of its business advisory board. He is an adjunct faculty member at Harvard University and has been a guest lecturer on investment policy and hedge funds at the Wharton School, University of Pennsylvania. Ricardo was awarded the Certified Investment Management Analyst® (CIMA) designation in 1993 and has published numerous articles on hedge funds.

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RISKS

There are risks involved with investing, including loss of principal. Past performance does not guarantee future results, share prices will fluctuate and you may have a gain or loss when you redeem shares.

Borrowing for investment purposes creates leverage, which can increase the risk and volatility of a fund.

Debt securities are subject to interest rate risk. If interest rates increase, the value of debt securities generally declines. Debt securities with longer durations tend to be more sensitive to changes in interest rates and more volatile than securities with shorter durations.

Derivative instruments involve risks different from those associated with investing directly in securities and may cause, among other things, increased volatility and transaction costs or a fund to lose more than the amount invested.

Investing in exchange-traded funds (ETFs) will subject a fund to substantially the same risks as those associated with the direct ownership of the securities or other property held by the ETFs.

Foreign securities, especially emerging or frontier markets, will involve additional risks including exchange rate fluctuations, social and political instability, less liquidity, greater volatility and less regulation.

Short selling involves additional investment risks and transaction costs, and creates leverage, which can increase the risk and volatility of a fund.

Investing in smaller companies generally will present greater investment risks, including greater price volatility, greater sensitivity to changing economic conditions and less liquidity than investing in larger, more mature companies.

Alternative strategies typically are subject to increased risk and loss of principal. Consequently, investments such as mutual funds which focus on alternative strategies are not suitable for all investors.

Definition of Terms

10-year U.S. Treasury is a debt obligation issued by the U.S. Treasury that has a term of more than one year but not more than 10 years.

Drawdown is the gradual decline in the price of a security or other investment between its high and low over a given period.

Price-earnings (P/E) ratio is a measure of the price paid for a share of stock relative to the annual income or profit earned by the company per share. A higher P/E ratio means that investors are paying more for each unit of income.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy. One cannot invest directly in an index.

Valuation is the process of determining the value of an asset or company based on earnings and the market value of assets.

Broadmark Asset Management LLC is the subadvisor to Salient's tactical equity strategies.

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