



Domestic TAA Is To Global TAA What The Calculator Is To The Desktop Computer

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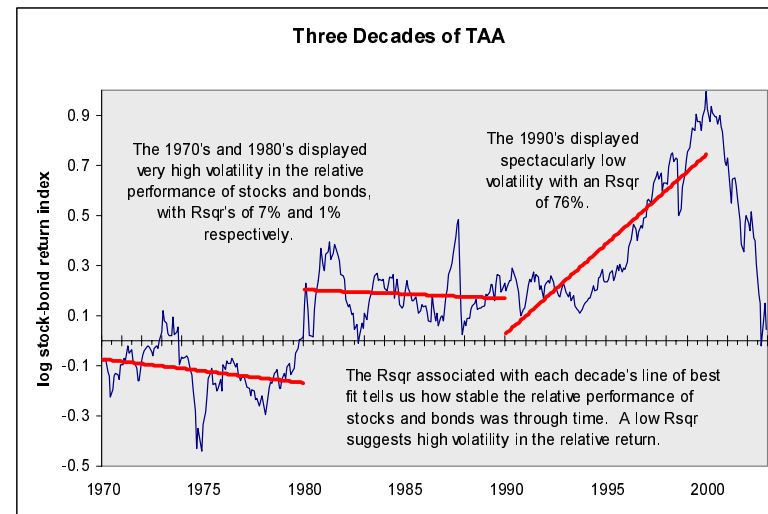
Tactical Asset Allocation was born in the 1970's as a strategy that actively managed the mix of stocks, bonds and cash. As such, it was focused on making an *asset class* decision, and simple measures of long-term fair value were at the core of this decision. There was a simple principle at work in the 1970's that lead to its outstanding success in that decade: there were frequent instances where the relative performance of stocks and/or bonds moved far away from their long-term fair values before reverting back. Volatility and mean-reversion were alive and well, and TAA was adept at exploiting the opportunities created.

The 1980's saw a continuation of quite similar market conditions. Volatility in relative asset class performance remained very high, and there were sufficiently frequent opportunities created to allow TAA to generate a great deal of value added. TAA's opportunities in the 1980's were not limited to the 30% tumble in equity prices in 1987 alone, even though that particular opportunity created the largest single, short-term opportunity for TAA ever seen since the inception of the strategy. Rather, the decade as a whole offered a great deal of opportunity to TAA.

We have discussed in great detail in previous Partners Messages the fact that the 1990's offered very little opportunity for TAA to add

value. We won't belabor that point here. Suffice it to say that, as Exhibit 1 makes clear, the 1990's were a decade where stocks outperformed bonds with spectacular consistency, and as a result, offered little opportunity for TAA to add value through regular shifts between stocks and bonds.

Exhibit 1



FQ Internal

What we want to focus our comments on here, is the product that arose out of TAA's successes in the 1970's and 80's. The 1980's saw the application of TAA broaden into non-US markets with the launch of Global TAA. What is not well understood about the globalization of TAA is that the product thus evolved into far more than simply an application of Domestic TAA across multiple markets. A common assumption about Global TAA is that its superiority over Domestic TAA stems from the diversification benefits of applying the same strategy in multiple



markets simultaneously. That's not correct. At least with respect to First Quadrant's approach to Global TAA, that isn't correct.

The hand held calculator is a brilliant tool giving us the ability to run calculations in seconds that would take us far longer to make by hand. Now that same functionality resides within today's modern desktop computer. But computational power is only one of the many useful functions that the modern desktop computer provides. Not only does it do calculations, but it processes words, images and sounds as well. Like today's desktop computer, Global TAA delivers much more than its predecessor: it does more than managing an asset class mix. This is well beyond the original purpose of domestic TAA.

Idiosyncratic Risk in the Domestic Asset Class Decision

What the Asset Allocation decision regards, whether strategic or tactical, is the allocation of capital to the major asset classes such as stocks, bonds, cash, real estate, and alternatives. Decisions regarding allocations *within* the major asset classes, especially in the selection of individual markets, are not usually deemed part of the Asset Allocation decision.

Tactical Asset Allocation decisions are, therefore, shorter-term decisions regarding the allocations to major asset class categories. The name "Tactical Asset Allocation" was therefore appropriate for Domestic TAA because Domestic TAA focused on the allocation to stocks, bonds and cash at the asset-class level.

While it is possible to devise an approach toward Global TAA that is simply a multi-country extension of Domestic TAA, wherein each market is treated as a separate and independent entity, this simplification ignores some of the chief benefits provided by the global approach. A more studied approach toward global TAA, consistent

with First Quadrant's global TAA strategies, addresses the asset class decision from a truly global framework. This is important because we find that the global stock vs. bond return is more reliably predictable than each of the domestic stock vs. bond returns.

Imagine that you could successfully predict when growth would outperform value and visa versa. What would happen if you were only allowed to use one growth stock and one value stock to exploit your forecasting advantage? Your success in choosing between growth and value would depend substantially on whether your value stock and whether your growth stock tracked the value or growth return. In other words, you'd be exposed to a great deal of idiosyncratic risk.

At a time when you thought that value should outperform growth, you might find that your particular value stock behaved unlike other value stocks because it ran into its own unique difficulties, while your growth stock had unusual success and outpaced all other growth stocks over the period. Your particular growth stock may have outperformed your particular value stock even during a period when value outperformed growth on average across the broad market. Diversified allocations to a basket of growth stocks and a basket of value stocks are the way one minimizes the idiosyncratic risk.

Because the asset class return is dominantly a global phenomena (see the box below), TAA finds itself to be exposed to substantial idiosyncratic risk when it is only allowed to invest in one equity market and one fixed income market. Idiosyncratic risk was evident when US equities, for example, experienced a more extreme form of bubble-like behavior (relative to other equity markets) throughout the latter half of the 1990's. Idiosyncratic risk was similarly apparent in Japan throughout the 1990's as a whole host of economic and political problems affected the Japanese market in ways that were unique to it at the time.



Global Returns Explain a High Percentage of Local Returns
Table 1

	Stocks vs. Cash (1993-2002)		Stocks vs. Bonds (1993-2002)	
	Adj Rsqr	Coeff	Adj Rsqr	Coeff
Netherlands	82%	1.17	86%	1.23
France	77%	1.16	83%	1.2
UK	76%	0.79	74%	0.81
Germany	75%	1.31	80%	1.39
Spain	75%	1.29	79%	1.27
Sweden	68%	1.4	68%	1.41
US	68%	0.82	69%	0.95
Norway	66%	1.13	70%	1.13
Switzerland	65%	0.93	68%	0.96
Canada	61%	0.88	62%	0.87
Denmark	58%	0.93	63%	0.94
Australia	57%	0.64	51%	0.6
Belgium	54%	0.81	61%	0.87
Italy	51%	1.1	59%	1.11
Austria	44%	0.8	47%	0.84
Hong Kong*			46%	1.29
Singapore*			54%	1.26
New Zealand	40%	0.76	38%	0.71
Japan	30%	0.66	28%	0.71

* Hong Kong and Singapore do not have bonds against which meaningful relative returns can be calculated.

FQ Internal

Approximately 55% of local excess equity returns (excess of cash) can be explained by the global (equal weighted) equity return over the recent 10 years, while 62% of the local relative performance of stocks and bonds can be explained by the global performance of stocks vs. bonds. In both respects, The Netherlands displays the least amount of idiosyncratic risk, while Japan displays the greatest degree of idiosyncratic risk. All this implies that the global asset class returns on stocks is the single most important determinant of individual market returns.

When allowed to manage the *global* asset class decision rather than a domestic asset class decision, our own success rate rises substantially because, we believe, we are less exposed to idiosyncratic risk when making a global decision. For example, over the 1980-2002 period, and using the investment models we have in place today, we would have been right in 60% of the quarters had we been limited to choosing between US stocks and US bonds, compared with an impressive 70% of the quarters had we been choosing between global stocks and global bonds instead. In risk-adjusted space, this translates into a difference in information ratio that is 20% better when managing the global asset class decision vs. the domestic asset class decision.

In Exhibit 2, we've simulated the value added that would have been achieved with our current investment model from either managing a US-only stock/bond decision or a global stock/bond decision. Clearly, the global stock/bond decision adds value on a more consistent basis, while the domestic stock/bond decision is more epi-

A word about simulation results:

The empirical evidence presented in this Partners Message is all based upon historical simulation. Normally, one should discount heavily any results based on historical simulation, as simulations are always vulnerable to backfitting.

In this case, however, what we are focused on is the *relative* rather than the *absolute* merits of two strategies, both of which are equally vulnerable to an inflation of returns due to the hindsight bias that is always imbedded in simulation analysis.

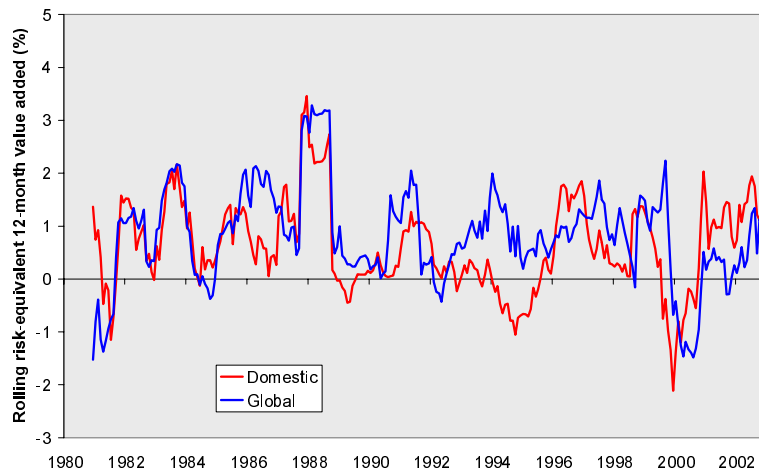
The point: pay attention to the *relative* attributes of the two products.



sodic. This, we would expect, will reduce the duration of those painful periods experienced while waiting for a resumption of fair value and will increase the frequency with which one is rewarded for taking contrarian asset class positions.

Exhibit 2

Asset Class Value Added



Please see Additional Disclosure found on page vi, number 1, 2, and 3.

In a sense, our desktop computer is the turbo version of the hand held calculator. Global TAA, as it relates to making only an asset class decision, similarly does do what Domestic TAA can do, only it does it much better.

Value Added From Country and Currency Selection

The second key distinction between the domestic and global approaches to TAA is that in the global approach, the Asset Allocation decision is only one of four distinct and equally important decisions made in the strategy, while in the domestic approach, the Asset Allocation decision *is* the strategy.

In addition to managing the mix of the three asset classes within its control - stocks, bonds and cash - Global TAA also seeks to make country selection decisions within the equity asset class, country selection decisions within the fixed income asset class, and to manage the currency exposures of the global portfolio. Whereas Domestic TAA's value added depends upon only one of these four legs, Global TAA has gone well beyond that.

It is now well understood across the investment management industry that combining unique, and uncorrelated sources of alpha is critical to building a more stable, more consistent success rate. Institutions recognize the advantages of hiring multiple equity or bond managers who might have low correlations in their streams of value added; Fund of Funds managers seek to combine relatively uncorrelated strategies; consultants recommend multiple managers and study the correlations of return between the managers. At First Quadrant we routinely assemble products out of an array of uncorrelated streams of alpha. Our equity products are structured that way, with diversifying factor, industry and asset-specific risk models used in combination with each other, as is our largest hedge fund product with its use of four uncorrelated strategies. Global TAA is no different in this respect.



As can be seen in Table 2, our simulations of the current investment model show that the correlation of value added from each of the four strategies imbedded in Global TAA is, indeed, quite close to zero, ranging from a high of 17% to a low of -5%.

Correlations of the Four Sources of Global TAA Alpha

Table 2

	Asset Class Selection	Equity Market Selection	Bond Market Selection	Currency Selection
Asset Class Selection	1	0.16	0.01	-0.01
Equity Market Selection	0.16	1	-0.05	0.17
Bond Market Selection	0.01	-0.05	1	0.08
Currency Selection	-0.01	0.17	0.08	1

Please see Additional Disclosure found on page vi, number 2 and 3.

Table 3 shows just how powerful the combination of uncorrelated strategies can be. The four strategies combined double the information ratio of TAA. Along with the doubling of the information ratio, the consistency of alpha on a quarterly basis rises from 60% to 82%. It is worth noting that all of the four strategies included in the Global TAA product outperform the Domestic TAA strategy both in terms of information ratio as well as in terms of quarterly consistency of success.

Table 3

	Domestic	Global				
	TAA	TAA	Asset Class Selection	Equity Market Selection	Bond Market Selection	Currency Selection
% Positive quarters	60%	82%	70%	66%	68%	77%
Value Added (%)	2.67%	3.56%	1.10%	1.51%	0.18%	0.97%
Tracking Error (%)	4.38%	2.79%	1.48%	1.84%	0.22%	0.90%
Information Ratio	0.61	1.27	0.74	0.82	0.81	1.09

Please see Additional Disclosure found on page vi, number 1, 2, and 3.



Conclusion

Much has been misunderstood about TAA. The late 1990's falsely led many to believe that TAA could no longer deliver value added. That belief was based upon a misunderstanding of the opportunities, primarily from a Domestic US perspective. Domestic TAA, as a substantially limited version of TAA, should not be expected to add value during the course of a raging bull market where stocks persistently outperform bonds. Instead, it should be expected to add value across a full market cycle, as well as during times of market turbulence (specifically during times when the volatility of the stock vs. bond return is high). The 1990's were a difficult environment for US Domestic TAA. But hindsight now shows that as the expected market correction finally began to unfold in 2000-2002, TAA demonstrated that it was still a vital strategy. From the perspective of a full market cycle, TAA now appears to have offered a reasonably cheap insurance policy throughout the 1990's that was badly needed and greatly rewarded when the new decade hit.

The great misunderstanding of Global TAA stems, in part, from the unfortunate name that Domestic TAA managers gave to the product. Domestic TAA is a strategy of managing the asset class mix, i.e. of managing the mix of stocks and bonds. Global TAA is much more than that, and perhaps another name would have made that more apparent. First, it manages the mix of global stocks vs. bonds. In a world where relative asset class performance is driven more by global conditions than by domestic conditions, managing the global asset mix is likely to be more successful. The global asset mix is more forecastable and contains less idiosyncratic risk, just as an index contains less idiosyncratic risk than a single stock.

Second, Global TAA combines four investment strategies, only one of which regards the decision on the asset class mix. Country selection for stocks, country selection for bonds, and currency management are all largely independent sources of alpha that complement the global asset class decision within Global TAA. The combination of these four,

uncorrelated strategies makes Global TAA a more consistent performer than Domestic TAA should ever be expected to be.

Finally, Exhibit 1, presented at the beginning of this article calls out to us. It begs us to ask the question, What will the remainder of this decade look like? Will the relative performance of stocks and bonds look more like the 1990's or the 1970's and 80's? Do we expect a continuation of high volatility and high levels of uncertainty, or do we think that this will be a decade of calm? So far the answer is clear: this has been a time of great uncertainty and high volatility, and as such, it has been a wonderful environment for both Global and Domestic Tactical Asset Allocation. We expect it to continue to be so.

Additional Disclosures:

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

- 1) Domestic Simulation: US 60% equity/40% bond benchmark. All returns shown are net of simulated transaction costs of 10 basis points for stock and bond indices.
- 2) Global Simulation: 50% hedged, global balanced (60% equity/40% bond) benchmark of 13 countries/regions: Australia, Canada, EMU, France, Germany, Hong Kong, Italy, Japan, the Netherlands, Spain, Switzerland, the UK and the USA, where the benchmark is cap-weighted based on MSCI indices. Ranges are +/-10% in all markets and global stocks and bonds are limited to +/-10% as an asset class as well. Cash has a 0% weight in the benchmark, but may be held +/-10% actively. All returns shown are net of simulated transaction costs of 20 basis points for stock indices and 10 basis points for bond indices.
- 3) All Simulations: Simulation results presented use signals generated by First Quadrant, L.P.'s current models. Simulated returns do not represent actual trading and may not reflect the impact that material economic and market factors might have on the adviser's decision-making if the adviser were actually managing a client's assets.