



Where TAA and Market Timing Part Company

*Max Darnell, Chief Investment Officer
First Quadrant, LP*

Market timing has received a great deal of press lately. No less than Peter Bernstein has come out in favor of timing the markets, and the interest is visible everywhere. Most investors tend to have either a strong view in favor of or against – it's somewhat black and white - and people speak vocally about their views on this subject. There was certainly no shortage of views shared with Peter Bernstein in response to his January Endowments & Foundations talk where he advocated Market Timing. He told a reporter at the Wall Street Journal that he was "flabbergasted" with the number of responses he received.¹ Everyone has a view, but are investors clear about the issues related to Market Timing? Probably not.

Market timing stands at the very core of what *active* management is all about: it's "buy low, sell high." If some investors aren't convinced that they know whether an asset they are trading is expensive or cheap, they at least have an expectation about whether it is going to rise or fall. Investors are at least trying to time

¹ "Bernstein's Shocking Words: Market Timing." *Wall Street Journal*, Wednesday, August 27, 2003

their trades so that they buy assets before they rise and sell them before they fall. That's still timing.

If *Market* Timing ("Market Timing" specifically refers to index level decisions) is no different from the timing implied by the buying and selling of individual securities, why is it so controversial in some circles? The wrong answer is that, "It can't be done." To take that perspective, one must explain why a buy low, sell high strategy might work at the individual asset level but not at the market level. We're unaware of anyone ever laying out anything substantive in terms of logic to support such an argument.

There was a popular press book released just this year under the title, "Yes, You Can Time the Market!" While the title sounds more like a pitch that you'd hear on late night TV – written to appeal to the same people who'd buy a can of spray-on hair to solve their baldness "problem" – in it, Ben Stein and Phil DeMuth provide wonderfully simple examples of how one could have successfully timed the US stock market over the last 100 years. They aptly demonstrate that simple metrics of Price-to-Earnings, Price-to-Book and Dividend Yields would have been very effective timing tools.²

What they don't point out as clearly is what the two essential problems with Market Timing really are. To be fair, they do tip their hat to the two problems – they just don't give them enough weight in their commentary to ensure being noticed. The first "problem" with Market Timing is that it is inherently contrarian and is, therefore, an

Market Timing is inherently contrarian and is, therefore, an uncomfortable strategy.

² For a more academic review of such strategies, see: Bauer, Richard J., Jr., and Julie R. Dahlquist. "Market Timing and Roulette Wheels." *Financial Analysts Journal*, vol. 57, no. 1 (January/February 2001), pp. 28-40, or for a recent academic example of such an application see Shen, Pu, "Market Timing Strategies That Worked." *Journal of Portfolio Management*, Winter 2003

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uncomfortable strategy. “Moving with the herd is psychologically gratifying, and gives us a feeling of security – even if the herd is rushing off a cliff. Relinquishing this safety blanket is the emotional price that must be paid for getting outsized returns by Market Timing.” I wonder how many of you will find the following hauntingly familiar when the authors go on to say that, “This emotional price is real, as you may see the next time a bubble hits and you ogle a new Lexus in the driveway of your idiot day-trading neighbor.”³

Discomfort then, presents a challenge to the acceptance of the strategy, but the more important problem is that the rewards to Market Timing accumulate over longer time horizons than most investors have the patience for. Markets may trade at excessively high (or low) levels for years at a time before a market correction occurs. As Stein and DeMuth demonstrate, the rewards improve incrementally as one shifts one’s attention from a five-year to a ten-, fifteen- or even twenty-year horizon. The longer the time horizon over which the rewards to Market Timing are measured, the better the rewards.

Unfortunately, the investment management profession has been geared for a time horizon much shorter than the time horizon attached to Market Timing. Few are willing to wait for more than two or three years to see their own strategies, or their active managers’ strategies, deliver the goods. Even if it is the right thing to do from a long-term investment perspective, it may be a career-endangering move to show such patience.

One more reason why market timing is so often considered a “dangerous” strategy is that it seems to imply taking very large risks. Market Timing is sometimes thought of as a binary decision for investors – you’re either in the market or you’re out. If it’s not thought

³ Stein, Ben and Phil DeMuth, *Yes, You Can Time the Market!*, John Wiley & Sons; 1st edition (April 4, 2003), pg 23.

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of in that way, it tends to imply very large shifts in the asset mix that in turn imply very large risks at the fund level.

From Market Timing to Tactical Asset Allocation

Because of these issues, Market Timing hasn’t become a product in and of itself that is broadly sold in the marketplace. Instead, those who find favor with the notion of Market Timing tend to turn towards Tactical Asset Allocation (TAA) which shares some of the same aspirations as Market Timing. TAA, however, has gone well beyond the more basic approach that Market Timing represents. It differs from simple market timing in a number of respects. Most notably, TAA practitioners have taken three steps that seek to minimize the investment-horizon problem, and to therefore minimize the corresponding need for outsized patience.

First, TAA does not apply a binary choice to the problem whereby you’re either in the market or out. Instead, TAA varies the degree to which you’re in or out of the market. The principle advantage of this is that value can be added in the absence of dramatic market swings, and can capture some value by varying, at the margin, the exposure to an asset class. Because risk taking in TAA is somewhat more continuous over time than it is in Market Timing, TAA can, and should be, applied in a rigorous risk budgeting environment.

Second, an effort is made to determine whether the surrounding market and economic environment supports a reversion in market valuations back towards fair value. Changes in the interest rate environment, for example, may take the pressure for a correction off if yields are falling, or may act as the much-needed catalyst for a market correction when yields are rising. This helps the investor to “time” the

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use of Market Timing, if you will. Ironically, this is more a matter of “timing” than using valuation to choose when the market is expensive or cheap. Market Timing strategies based on PE, for example, could be criticized for their lack of timing!

Third, by globalizing the approach, we build a portfolio of market timing decisions in much the same way that a stock investor builds a portfolio of individual stock timing decisions. This improves significantly the frequency with which relative returns on stocks, bonds and currencies offer opportunities to add value.

By globalizing the approach, TAA builds a portfolio of market timing decisions.

Our own global approach to TAA has added value in 7 out of 9 years, while the domestic-only version of TAA failed to add value over the six-year span from 1994-1999. True, domestic TAA added substantially more than it had given up once the bubble broke, but few stayed the course after six years of no value added to profit from the full market cycle. By globalizing the approach, value *can* be added over horizons that don't exceed the tolerance of institutional investors who tend to look for strategies that are profitable on at least a three-year rolling basis.

The Arguments Against TAA

Amongst the objections put forward to TAA, the association of TAA with Market Timing is the one raised most frequently. Clearly we think that TAA is a modern vehicle that handles the twists and turns of a market cycle far better than the old Model T that is Market Timing. TAA is capable of overcoming the objections to Market Timing for the reasons outlined above.

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There are two other objections that we hear sometimes lobbed at TAA. The first rests primarily upon the formula put forth by Grinold and Kahn that expresses the risk-

adjusted reward of an active strategy as relying upon the number of independent bets made in a portfolio, along with the skill level applied to making those bets. TAA is criticized on the grounds that it has far fewer assets to play with than, for example, your typical stock portfolio. The former may have only thirty or more liquid futures and forward contracts to work with, while a stock portfolio may have as many as five hundred, a thousand, or even more stocks to choose between.

We have argued in a previous Partners Message⁴ that the difference in number of *independent* bets in a stock portfolio and in a global TAA portfolio may be less significant than the mere difference in the number of assets would suggest. Grinold and Kahn have themselves sought to clarify that independence is the key, not the number of assets. We've also stressed the importance of transactions costs in this equation (it's missing in Grinold and Kahn's statement of the equation). Forecasting skill is diminished after transactions costs because the rewards to making successful bets are diminished by the cost of placing those bets, but also because in the presence of high transactions costs, a large share of the information at hand will simply have to be ignored – potential bets won't be made - when the expected transactions costs exceed the expected gain.

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But there is a more important point that we made there than either of these two points, and that is that strategies should not be evaluated on their ability to add value in a vacuum, but rather they *should be evaluated for their ability to add value to a portfolio of active strategies*. While it may not yet be conventional in practice, the assembly of a portfolio of active strategies should be treated as an optimization exercise. For the most recent and most insightful

⁴ Darnell, Max and Ken Ferguson, “Thoughts on Grinold & Kahn's ‘Fundamental Law of Active Management’,” *First Quadrant Partners Message*, November 2000.



incarnation of this, see Waring and Siegel's recent article in the Journal of Portfolio Management.⁵

The issue comes down to this. When you allocate that next chunk of active risk out of your active risk budget, should you hire yet one more active equity manager, or should you hire a TAA manager? Unless you have very few active equity managers, the next one is not likely to add nearly as much to the overall risk adjusted return as the first one(s). There are simply a limited number of market inefficiencies in any one asset class to exploit. TAA introduces a different (and typically underexploited) set of market inefficiencies into the mix, and, should, therefore, add more *marginal* value added than yet-one-more active equity manager should be able to add.

If the pattern of value added of a strategy is low or even negatively correlated to the mix of other active strategies, then such a strategy stands a higher chance of improving the risk-adjusted return at the fund level, even if it's own risk-adjusted return is lower than the average strategy. This is an engineering exercise, and engineering is not always consistent with our more basic intuitions.

There are those who have even argued that a strategy that loses money can improve the risk-adjusted return of a portfolio of active strategies if its correlation is negative. While that's mathematically correct, it's not likely that many, if any, would choose to take on losing strategies even if they did produce the desired improvement in the overall active return. The point is forceful nevertheless. It's not the risk-adjusted return of the strategy itself that makes it valuable to an active investor. Rather, it's the ability of the strategy to improve the overall risk-adjusted return of a portfolio of active strategies that the investor should value. TAA should tend to be an excellent complement to other active strategies and should improve the overall performance as a result.

⁵ Waring, M. Barton and Laurence B. Siegel, "The Dimensions of Active Management." *The Journal of Portfolio Management*, Spring 2003.

While this leads us somewhat away from our principle focus, there is another objection to TAA that we hear, albeit less frequently, and that we might as well deal with here where we've dealt with all of the other objections. TAA can be described as making both country selection and asset class selection decisions. Evidence was presented in published papers right after the top of the bubble had been reached, suggesting that sector returns had become more important than country or asset class returns in explaining the time-variation in individual stock returns. Because of this, and because of the fact that index futures are defined by their country exposure, not by their sector exposure, some have questioned the continued use of country selection in TAA.

Note that there is a question as to how dependent these results are on the bubble behavior in the late 1990's that exaggerated the importance of sector returns. We argued that point in a previous Partners Message,⁶ suggesting that the effect was based on bubble behavior. A recent paper by Kritzman and Page⁷ presents evidence in support of our earlier view that the growth in the importance of global returns has turned out to be transitory.

But whether the conclusion drawn is correct or not is beside the point. Investment strategies should not be chosen based upon a "hierarchy" of asset returns. Had it turned out to be the case that sector returns *were* more important than country returns, that still wouldn't have meant that country selection strategies would be dead. That would be ludicrous. What matters is where you can obtain the best (marginal) risk-adjusted return. If sector returns are important, then they may be

⁶ Darnell, Max, "Sector Rotation: The New Holy Grail or the Latest Fad?" *First Quadrant Partners Message*, March 2001.

⁷ For a valuable recent discussion related to the hierarchy, see: Kritzman, Mark and Sebastien Page, "The Hierarchy of Investment Choice." *Journal of Portfolio Management*, Summer 2003.



important to forecasting relative country returns. Since trading countries through futures is far cheaper than it is to trade cash securities to effect changes in sector exposures, country selection would likely still be a more efficient means of exploiting information about relative sector returns!

The Case For TAA

To state the obvious, the most important basis of support for using TAA is that it works. It has worked on its own, and it appears that it has worked well as a complement to other active management strategies.⁸ TAA may work even better than its recent (successful) track record may suggest. The performance of an investment strategy is ultimately subject to whether the market presents it with the opportunities it would hope to exploit. A big part of what TAA managers have sought to exploit is the interplay between the stock and bond markets.

What interplay, you might ask? In the US, stocks pretty much just beat bonds over and over again from 1994 through 1999. In only 5 out of 24 quarters did bonds beat stocks, and in only two of those quarters did bonds beat stocks by a *meaningful* margin. If TAA is going to profit from shifting back and forth between stocks and bonds, then it needs volatility in the relative return of stocks and bonds. The decades of the 1970's and the 1980's offered just that kind of volatility, and TAA in its domestic form performed very, very well then. It would appear to us that the present decade will offer a similar level of volatility. This decade has, so far, been fantastic for TAA.

Good performance is obviously important, but there are other aspects

⁸ Comparisons of our own TAA results with other strategies have suggested that it tends to have a low correlation with other kinds of active investment strategies.

The most important basis of support for using TAA is that it works!

of TAA which should earn it a place in most institutional portfolios. Most important on this list is the fact that so few active managers are competing to profit from the same inefficiencies. TAA, while widely used is not used as widely as other conventional strategies. If you're going to look for strategies that add value, where do you want to look? Do you want to look where few others are looking, or do you want to compete with the masses? Unsurprisingly, we'd suggest that you're more likely to win profits if you exploit those market inefficiencies where you have less competition.

Beyond that, we would point to the advantages of utilizing the conventional asset classes in the seeking of value added. It is particularly interesting when we think in terms of increasing exposure to alternative assets or absolute return seeking portfolios. As the total assets committed to alternative asset portfolios continue to grow, the role of conventional asset classes in seeking alternative return profiles continues to rise. Not only do we see equities deployed in a market neutral framework attracting assets, but interest is on the rise for TAA as well which uses highly liquid stock index futures, bond index futures, and currency forwards. Market Neutral equity and TAA both represent approaches that *employ conventional assets to achieve unconventional returns*. Both strip out the conventional asset class return, and instead, deliver pure value added which can either be ported to another asset class return or not.

Conventional assets have two characteristics that make them both particularly attractive instruments on their own regard, and easier to "sell" internally to the committee or the board. First of all, the conventional assets have become "conventional" because we have grown very familiar with them. We know better, therefore, what the risks are entailed in holding them than we do about the risks of more

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esoteric sources of return. Because we know better what the risks are, we are better able to manage those risks.

Furthermore, the assets employed in TAA have tremendous liquidity and transparency. Again, this is especially interesting in the alternatives world where liquidity and transparency are lacking in many of the alternative strategies. (Some of the alternative strategies earn their profit by being paid to absorb illiquidity by being a liquidity provider.) Let's face it, there isn't enough liquidity in merger arbitrage, high yield, or distressed debt to accommodate the growth in hedge funds that would occur if the role of alternatives was to become widely accepted by, and significant in allocation for, the institutional marketplace. Were we, on the other hand, to simply redeploy

all of the active assets employed today in these conventional asset classes into long-short or market neutral approaches at the same level of risk, that would probably amount to more alternatives capacity than the market would ever seek in total, and be just as transparently priced.

Not only have we seen equity market neutral being used to fill a significant slice of the alternatives pie, but more and more of our TAA and currency programs have either been launched with the long-short framework and cash benchmark appropriate to alternatives programs, or existing overlay mandates have been restructured to serve that end.

Conclusion

Market Timing has earned back some measure of respect based principally upon the fact that we've had a dramatic market correction. Market Timing worked. It has also gained interest from people like Peter Bernstein because he and many others expect this to be a decade of lower asset class returns accompanied by greater volatility. That's a better environment for Market Timing, and it's a better environment for TAA.

When it comes to turning that interest into action, the answer is Tactical Asset Allocation. TAA brings with it a similarly objective and contrarian flavor, but it applies the concept of Market Timing in a much more diversified portfolio approach that reduces the need for outsized patience. Furthermore, TAA seeks to understand more than just whether the markets are expensive or cheap by asking whether there are catalysts in place that might lead now to the reversion that Market Timing waits for.

The typical objections raised with respect to TAA fall away when we treat the building of portfolios of active strategies as an optimization exercise. This requires us to treat the building of active portfolios as an engineering activity, taking into account the whole portfolio of active strategies rather than dealing with them one by one. (Doesn't that sound like something that Harry Markowitz and Bill Sharpe said some years ago about how to manage stocks?) In that context, there is reason to believe that TAA will add more value at the margin at the fund level than most other heavily utilized strategies can deliver at the margin. On top of that, TAA brings with it liquidity, transparency and capacity – elements that will be increasingly difficult to find in the alternatives world.



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