

# Using strategic tilting to take advantage of market extremes

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## Your questions answered with Andrew Pease

Chief Investment Strategist, Russell, Asia Pacific



**Strategic tilting is a 'high conviction' approach to asset class timing. Here Andrew Pease shares his views on Russell's strategic tilting capability. When done in a risk controlled manner, this investment process offers investors the scope to enhance the long-run performance of their portfolios.**

### What is strategic tilting?

The idea behind strategic tilting is very simple. It aims to take advantage of extreme market movements. We can use it to temporarily adjust or 'tilt' a portfolio's risk exposure from its long-term default strategic asset allocation (SAA) in response to changes in expected returns. It's based on the belief that markets are not fully efficient and may be occasionally mispriced.

### When is it used?

We use strategic tilting when an asset class moves to an extreme compared to its long-term average valuation and conditions begin falling into place for valuations to re-adjust back to their average level. When it's done in a risk-controlled manner using a robust process, investors can use strategic tilting to enhance the long term risk-adjusted returns of their portfolios.

### What are the 'must haves' in a strategic tilting investment process?

To be successful, you need to have four key elements in place:

- 1) An ability to identify unsustainable market extremes** - stretched valuation levels are essential but investors also need to focus on the forces that have driven the market to an extreme level and why they're not sustainable in the long term.

- 2) Criteria for entering a position** - these should be based not just on price level, but should also incorporate timing signals. These signals are designed to identify when the market is about to re-adjust back to its average level. For a tilt to be classified as high conviction, you need to see very strong evidence supporting it.

- 3) Criteria for exiting a position** - a clear exit strategy is needed so that you know which conditions will cause the trade to be closed. This means that you need to initially establish a set of market and economic indicators which track whether the tilting decision should be maintained or closed.

- 4) Strong governance** - it is essential that any investment organisation contemplating strategic tilting has a strong governance structure which enables committed, accountable and clear decision making - at all times.

### Is strategic tilting the same as tactical asset allocation (TAA)?

No. We're not a fan of TAA because there is not enough evidence that it's a reliable way to generate portfolio returns. There are two key differences between our strategic tilting process and TAA.

- 1) Strategic tilts are based on a **longer time horizon** compared with the typically short-term focus of a TAA strategy.



2) A fund manager following a TAA strategy is typically under pressure to be seen to be doing something in order to earn his or her keep. This can cause the manager to take lower confidence positions which creates unnecessary risk in an investor's portfolio. In contrast, we don't take any action under strategic tilting unless there is a relatively **high level of conviction** that markets are at an unsustainable and extreme level.

### Why is tactical asset allocation so difficult to do well?

TAA fund managers continually take short-term overweight and underweight positions based on their view of the market. The problem is it is very difficult to time the market or successfully exploit short-term anomalies in valuations. I've spent nearly 20 years trying to understand the ebbs and flows of financial markets. Knowing when to quickly get in and out of asset classes is definitely not an easy task. That's the reason why there are only a small number of TAA products around today. By contrast strategic tilting is a 'high conviction' approach to asset class timing. In plain English, this means that investment decisions are only made when they pass a set of clearly defined and rigorous decision making hurdles. Strategic tilting may only involve a few decisions in an investment cycle and if there is any doubt, no decisions are made.

### What are other market participants doing in this space?

There's no doubt that there has been an industry wide shift towards the adoption of some kind of asset class timing. Some investment managers are using market timing strategies in an attempt to protect downside risk, while others are claiming they can time markets to enhance performance. For more information on the different types of asset allocation paradigms in the market, refer to Russell's recent research report *"Dropping the pilot - do you need a Strategic Asset Allocation?"* (Harman, G. & Alles, M., Nov 2011).



### What are your tips on evaluating approaches to asset class timing?

I think it's important to remember that strategic tilting is only suitable for certain investors, in certain markets and at certain times. That's why choosing the right investment manager with the right process is so critical. Some questions to ask include:

- » Is the approach to asset class timing based on a well articulated philosophy of asset market behaviour?
- » Is there a clearly defined process and decision making framework in place?
- » Are exit rules in place for every trade?
- » How does the process differ from short-term TAA?
- » Can the process be implemented into your decision making structure?

**Our process is based on the principle "first do no harm". It is anchored in a strong belief in the SAA and a clear bias not to act unless there is high conviction.**

### How does strategic tilting fit with Russell's approach to investing?

One of our core investment beliefs is that deviations from SAA can be undertaken if they are approached cautiously, there is an appropriate decision making process in place and that success is commensurate with the risk involved. We have a long heritage in investment management and research, so strategic tilting is a natural fit for our business.

I've been at Russell for over five years now and our approach to strategic tilting continues to evolve as we refine our processes. One thing I've learnt is that Russell introduces investment innovations only after a long and intense debate. Strategic tilting is the outcome of the rigorous research based approach that Russell takes pride in.

### Does Russell have what it takes to conduct strategic tilting?

Strategic tilting complements our core investment capabilities, which include our long history of constructing portfolios to achieve risk and return outcomes for all types of investors. The research that goes into this provides us with a deep understanding of the long-term drivers of asset class performance and a strong framework for analysing when markets have moved to unsustainable levels.



Our other unique capabilities include our deep pool of global portfolio management resources and access to the world's top fund managers. These connections and relationships in the global investment community provide us with a very valuable source of intelligence and insights about what's happening in markets.

### **Who is responsible for identifying strategic tilt ideas at Russell?**

We take a very disciplined approach to strategic tilting. Each month, the Strategic Tilting Committee meets to generate investment recommendations. The Committee includes Symon Parish (CIO Australasia), Andrew Sneddon (Portfolio Manager, Diversified Funds), Greg Liddell (Managing Director, Consulting & Advisory Services), Graham Harman (Director of Capital Markets Research), Geoff Warren (Senior Lecturer in finance at the Australian National University) and myself. We've deliberately designed the Committee so we avoid 'group think' and all our ideas are rigorously evaluated. When we're focusing on a specific asset class, we also have access to external advice from asset class specialists like portfolio managers, manager research analysts and consultants.

### **What's an example of a strategic tilt?**

A good example is a tilt towards global investment grade corporate credit we executed in 2009. Credit markets ran into trouble in March 2008 and hit panic mode after the Lehman Brothers collapse in September 2008. Credit spreads widened considerably and we were able to capitalise on this opportunity when conditions for mean reversion began falling into place in June 2009. This position took 9 months to play out and we closed the tilt when credit spreads moved from 320 basis points at inception to 150 basis points, which was our exit target.

### **Do you have other tilts on or are considering at the moment?**

At this time we have a tilt against the Australian dollar that was initiated late in 2009. In early May 2011, we upgraded this tilt from low to medium level as the dollar approached 110 US cents. We have high confidence that the Australian dollar is at an unsustainable valuation extreme relative to our purchasing power parity estimate of 68 US cents. We also caution our clients against overweight positions in global government bonds as yields are extremely low, especially in the U.S. This view may become a strategic tilt in the future when catalysts for re-adjustment to more normal levels start falling into place.

### **Which asset classes are potential candidates for strategic tilting?**

Although this list is not exhaustive, some of the asset classes we're monitoring are listed below. We're willing to consider any good idea, provided it can be successfully implemented.

- » Equities vs. bonds vs. cash
- » Domestic vs. global or developed vs. emerging market equities
- » Small cap stocks vs. large cap stocks
- » Growth stocks vs. value stocks
- » Credit vs. government bonds vs. inflation linked bonds
- » Listed vs. unlisted assets
- » Currencies