2 Ways to Allocate Assets

The two dominant philosophies of asset allocating assets are strategic and tactical. The former is best for building wealth when the economic picture brightens, and the latter is better for dealing with uncertainty. Whichever method you favor, diversification is still the way to go.

Both asset allocation methods developed from the landmark studies by Gary P. Brinson, Brian D. Singer, L. Randolph Hood, and Gilbert L. Beebower in 1986 and 1991. The authors found that proper asset allocation is far more important than security selection, timing or any other factors for maximizing long-term investor performance.

When Brinson and Beebower put their beliefs into practice in their own companies, however, they each developed their asset allocation concepts in different directions.

Strategic asset allocation

Beebower started SEI, a company that became one of the largest strategic asset allocation shops available. Financial advisors use SEI as a third-party asset manager, effectively outsourcing the management of their clients' assets. A financial advisor selects an asset allocation appropriate for a client's situation.

For example, a middle-aged investor might require 60% equity and 40% fixed income investments. If the stocks in the portfolio rally, they increase the value of the portfolio, but the portion allocated to stocks increases. In this case, SEI simply rebalances back to that strategy by selling stocks and buying bonds. The strategic method was very successful throughout the 1980s and 1990s, but lost favor amidst the serial catastrophes of the dot-com bubble and the 2008 financial crisis.

Tactical asset allocation

His partner founded Brinson Advisors, which employs a different approach, tactical asset allocation, which follows the value investing maxim of buy low, sell high. A tactical allocation aims to acquire asset classes that are undervalued, and sell them as they get expensive. Of course, valuing asset classes takes significant skill and there is no guarantee that the manager is right. Tactical asset allocation became more popular in response to the Great Recession, as extreme volatility devastated strategically allocated portfolios.

To put these two styles of asset allocation into perspective, we have to see when they do well and where they fail. For Beebower's strategic asset allocation, the best period was between 1982 and 2000, when markets basically moved up every year to a large degree. In this scenario, we liken strategic allocation with setting the sails on your portfolio and going where the market winds take you.

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As long as market winds are at your back, you can easily achieve your financial goals. Once they become headwinds, a tactical manager who is not locked into a losing strategy can serve you better. Then, a tactical manager gets out the oars and rows the boat to your destination.

When an investor or advisor chooses one form of asset allocation over another, they are expressing a belief in the secular market cycle. We are all familiar with business cycles that last a few years with a boom or bust driven by investment in a particular industry or market sector. These happen all the time.

A secular bull or bear market is much stronger and can last much longer than a cyclical one, as long as 15 or 25 years. Major demographic shifts or overarching macro-economic policies drive secular cycles, and many shorter business cycles take place within them. For instance, through the 1980s and 1990s, the U.S. stock market was in a secular bull market. Significant downturns occurred along the way, but they didn't interrupt the prevailing upward trend until the dot-com boom went bust. At present, some advisors maintain

At our firm, we maintain both tactical and strategic asset allocations at all times. When we believe big picture valuations are good, we lean toward the strategic and set our sails. When we see valuations get too high, the public sector become excessively indebted or government policy dragging on economic progress, we lean toward the tactical and put more energy into rowing.

It takes humility and honesty to admit that we don't know for certain what the future holds. So we build portfolios that are certain to underperform in the best markets and outperform in the worst. Diversifying your asset-allocation strategy is a conscious decision to never make a killing for the priceless blessing of never getting killed.