Why is it that the industry dismisses significant changes to portfolio allocations as “market timing” transactions but embraces the subtler “tactical shifts” many advisors are making in the current, transitional market? As advisors debate the nuances of that question, the more relevant question may be: How would you respond if a client asked you to explain the difference between market timing and tactical asset allocation?

I spoke with several prominent industry practitioners to better understand the distinction between much-maligned market timers and tactical asset allocators, and to find out if there really is a difference between the two.

Nobody I spoke with called themself a market timer but, as you will see, their definitions were more art than science.

Nathan Sonnenberg, Chief Investment Officer at Fortigent, LLC, a Rockville, Maryland provider of investment research and performance reporting, insisted the difference between market timing and tactical asset allocation is black and white. “Market timing is an all-or-nothing approach applied to a specific asset class or area of the market,” he explained. “Should you sell out of stocks? Should you sell all your municipal bonds? Should you invest everything in commodities because emerging markets are poised for a decade of growth?”

Conversely, Sonnenberg said, tactical allocations involve relatively minor adjustments to a strategically allocated portfolio. “In a traditional portfolio split 60/40 between stocks and bonds, you might decide to increase your exposure to fixed income or, within the equity allocation, favor emerging markets over US or small-caps over large-caps to take advantage of differentials you perceive in the market,” he explained.

The all-or-nothing distinction was a common thread among those I interviewed. Sometimes, however, a market timer may stay fully allocated to a single asset class. Consider a day trader, who epitomizes market timing. Many day traders don’t routinely switch asset class allocations; they may stay invested in equities over an extended time period, albeit adjusting their positions daily.

Michael Kitces, Director of Financial Planning at the Maryland-based Pinnacle Advisory Group, agreed that market timing and tactical asset allocation are differentiated by degree and magnitude. “A five-percent shift is tactical, whereas market timing is all-or-nothing,” he said. Kitces also pointed to a difference in expectations. When advisors move all-in or all-
out of an asset class, he said, the implication is that they seek to be all-in when markets are going up and all-out when markets are going down.

“Rather than an absolute return strategy, where if you lose money you are a bad market timer, tactical asset allocation is built around more of a relative return story,” he explained. “You try to be underweight when an asset class looks a little risky and overweight when it looks a bit better. You don’t simply hold multiple asset classes and hope some zig while others zag. Instead, you try to not own as much of asset classes that may go down, hoping to make money in a bull market and not lose quite as much in a bear.”

Kitces illustrates the fuzziness in the distinction between tactical asset allocation and market timing; what he describes as tactical asset allocation is merely a milder version of his view of market timing.

In a recent post on his blog Nerd’s Eye View, written jointly with Ken Solow, Chief Investment Officer for Pinnacle Advisory Group, Kitces argued that the definition of market timing as retail day-traders moving in and out of positions based on very short-term market predictions needs to be updated. After all, while tactical investing involves subtle rather than wholesale portfolio moves, it, too, is opportunistic. And it’s that characteristic that may prompt clients comfortable with a strategic buy-and-hold approach to worry that their advisor is abandoning his investment management discipline by making a move to dial down portfolio risk or gain exposure to a new asset class.

Frequency of trading cannot be what distinguishes market timing from tactical asset allocation. Consider David Swensen, who heads Yale’s investment office. Swensen rebalances his portfolios daily, but few would call him a market timer.

Communicating with clients

While differentiating market timing from tactical asset allocation proved difficult, a clearer consensus emerged around how to communicate portfolio moves to clients.

Kitces, whose firm transitioned from a passive strategic approach to tactical asset allocation in 2002, tempers clients’ fears that tactical investing is thinly cloaked market timing by pointing out that the act of rebalancing annually to one’s strategic asset allocation involves an element of market timing. “Many advisors who had previously disagreed with me that rebalancing is a form of market timing came around to my point of view during the remarkable volatile fall of 2008,” he said. “The difference between rebalancing on the best day or the worst day of the market in September and October 2008 was a decade’s worth of returns because markets moved 10 to 20 percent over a couple of days.”

Glenn Frank, Director of Investment Tax Strategy at Lexington Wealth Management in Lexington, Massachusetts, has always used a tactical investment approach using
fundamental valuations to identify under- and over-valued asset classes. His decisions are guided by a question he says few advisors ever ask their clients: Is the portfolio a means to an end, or an end in itself? “If we agree the portfolio is a means to an end, then it’s easier not to get caught up in the moment trying to beat the market and instead work toward goals by focusing on risk management and tactical shifts,” he explained. “To be a strategic allocator and continually have rebalanced back to target in 2008 for fear being labeled a market timer would have really compounded some serious losses.”

Sonnenberg noted that advisors wishing to underscore the difference between market timing and tactical moves may consider sharing the research that drives their decisions with clients. Fortigent makes its analysis of macroeconomic factors, fundamentals and valuations at the regional and asset-class levels, technical and liquidity measures, and broad market risks available in both executive summaries and detailed reports. “Advisors report positive feedback when they share this information with clients,” Sonnenberg said.

Lou Stanasolovich, CEO and President of Legend Financial Advisors, Inc., in Pittsburgh, Pennsylvania, agreed that educating clients is crucial to increasing their comfort with tactical portfolio decisions. Accordingly, he has begun recording securities-market overviews that he emails to clients. “Our clients enjoy hearing from me,” he noted. “Next week we’ll begin liquidating some traditional bonds and moving to some more non-traditional vehicles that offer stability in a rising interest rate markets. I’ll describe to clients how we’ll probably double our position in bank loans and invest in a fund that goes long/short on Treasuries and a bond fund that long/shorts currency. I want them to understand the tactical shift and our expectations.”

In addition to discussing how he makes tactical portfolio decisions, Alan Galinsky, founder of the Arch Financial Group in Boca Raton, Florida, is careful to construct the “big picture” for his clients so they appreciate the necessity of portfolio changes. “There are very few people look at next 100 years in the US economy and think it will look very much like the last 100 years,” he said. “To adjust for that, we need to get clients on board with the fact that tactical changes are necessary now and will continue to be needed in the future. Once the US was the dominant force in manufacturing and consuming, but the middle class is exploding elsewhere.” Growth in emerging markets like Brazil is unbelievable, he said, and “we have an obligation to adjust for this in our portfolios.”

As two devastating bear markets in the space of a decade increase the pressure on strategic asset allocators to reduce risk and boost returns, the question of how market timing differs from tactical asset allocation will persist for advisors and clients.

“In the eight years since we began our transition to tactical management, we’ve gone from the bottom of the market, back to the top, and back down to the bottom, and tactical management has been a much more proactive and effective way to manage risk,” concludes Kitces. “Clients have gradually accepted our view that shifting a portfolio in
response to market valuation extremes does not constitute evil market timing, but is a prudent and constructive response supported by market fundamentals.”

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