The Tactical Approach
Challenging traditional asset allocation theory

Atlas Private Wealth Management

Atlas
A Connectus Partner

Preface

The following white paper outlines the Dynamic and Tactical Asset Allocation strategy that we at Atlas Private Wealth Management currently employ in the management of our clients' unrestricted portfolios. As research, data, information and quantitative methods have evolved rapidly in recent years, we feel it is vital to our client's interests that we stay abreast of contemporary approaches to asset management.

While new investment schemes come and go over time, certain strategies continue to produce generally positive investor experiences. That does not suggest though that these strategies cannot progress. The following could be described as the evolution of Modern Portfolio Theory (MPT), the traditional asset allocation method that has been practiced since the 1950's. We think that the enhancements to the traditional method are insightful, applicable for individual investors, and represent an improvement to the prudent approaches we have come to know over time.

While individual client circumstances do affect the specific investment choices made for many portfolios, the overall guiding principles of our investment strategy and discipline described here are implemented where appropriate. As we move ahead, we will work with all Atlas clients to provide an improved awareness of how our approach is currently applied to their personal portfolios, and provide recommendations on how we might more fully implement it to pursue investment goals.

Introduction

The strategy of diversifying assets across several investments or investment classes to reduce overall volatility is largely ubiquitous in the investment management industry. Over the last several decades, individual investors, retirement plan participants and institutions have become comfortable with the idea of combining bonds with domestic and international equities (stocks) into a portfolio that they hope will provide the highest return potential for a given level of risk.

While this is the currently accepted standard in the industry, we think this approach is limited, and does not adequately position the investor to potentially benefit from changes in the economy or business environment. Clearly, no single approach can dependably identify every opportunity for profit or eliminate all risks. We believe, however, that a dynamic and tactical approach to asset allocation grounded in thoughtful research and analysis can offer the possibility for investors to augment returns when compared to a static asset allocation approach.

Modern Portfolio Theory – The Basics

First introduced in the 1950's by economist Harry Markowitz, Modern Portfolio Theory (MPT) holds that statistical data on historical factors such as returns and volatility are important to positioning a portfolio for the future. Specifically, the degree of statistical correlations between asset classes are thought to be key. These correlation figures are used to determine the presumed "optimal" combination of asset classes to produce anticipated long-term portfolio returns at a given acceptable level of risk/volatility.

Correlation is a measure of the tendency of the returns of one investment (or category of investments) to move in tandem with those of another. Two investments that are "uncorrelated" would be expected to show no connection between their returns over time. A negative correlation indicates that there is an opposite relationship between two investments - i.e. when one decreases, the other increases.

This "portfolio optimization" uses historical returns and volatility statistics to calculate expected future returns.

Thus, MPT proposes that by looking at the past, and properly combining investment classes based on correlation factors, volatility can be diminished while portfolio performance can be optimized to a risk level.

As we have seen over the history of the markets from 1926 to the present, while equities provide the opportunity for superior returns, they tend to be more volatile. Conversely, bonds have historically exhibited less volatility, but tend to provide more modest long-term returns. In practice, we see that as investors grow older, they are inclined to allocate more of their assets toward bonds in an effort to reduce the overall volatility in their portfolio. People who are risk-averse follow a similar strategy. Individuals that are more aggressive typically place more in equities.

Using MPT, we can also look at correlations of sub-asset classes such as Small-Cap Value, Small-Cap Growth, International Equities, Emerging Markets, etc. Using this more specific level of analysis of returns and volatility statistics, we can attempt to create a more optimized portfolio.

Information on this approach is available, relatively easy to comprehend, and has become a typical framework for individual investors.

Is Modern Portfolio Theory Overrated?

In our view, the limitation of MPT lies in the idea that the past does not equal the future. The fact is that correlations of asset classes change over time as changes in the economy and the secular environment develop. Clearly, these changes can affect portfolio results over time.

Consider the following: Assume that we construct a portfolio based solely on MPT, and leave it invested for a period of ten or 15 years, rebalancing the allocations to their original targets annually. This approach is not uncommon for individual investors, based on commonly accepted advice. Then assume that the correlation of Large-Cap equities and Investment Grade bonds changes by 40% (this would be similar to seeing average July temperatures drop from 90 degrees to 54. It's meaningful). In this situation, the behavior of the allocation will change, and will not provide either the expected returns or the volatility characteristics that were originally projected.

In fact, the suggestion of changes in asset class correlations in confirmed in what has occurred in the early 2000's. Here in the U.S. we endured a financial crisis followed by an unprecedented period of governmental economic stimulus. In the subsequent "risk-on, risk-off" investment environment, the degree of correlation of treasury bonds and equities changed noticeably as assets flowed from one to the other in abrupt and pervasive swings. More recently, the correlation again changed. From 2014 through mid-2018, bonds and stocks were more positively correlated (rising and falling together) than they had been for decades.

In our judgment, these changes in asset class correlations may create unexpected outcomes for investors who allocated based on old data. Traditional asset allocation theory results in a relatively static approach to investing. While it provides a method to develop a solid foundation and starting point, the method does not provide guidance on how to adjust a portfolio to a changing secular, economic or business environment.

So how can an investor overcome these limitations?

We think that one should begin with the understanding that while MPT provides a solid foundation for the initial construction of a portfolio, it will require periodic adjustments as the correlations of asset classes to one and other change over time. From there one can move forward.

First, observing secular conditions and possible secular changes can help the investor to position their portfolio. These secular factors, or large shifts in the economy, may affect future returns and help determine starting points for an allocation.

Next, the investor could look at business conditions and how they impact various asset classes, sectors and industries. The investor should build an awareness of how the business cycle evolves, and how the fundamental drivers of returns for investments evolve with it. He/she would need to determine in what phase of the cycle the economy currently sits. This is vitally important, as the relative performance of certain investments or asset classes are, in some cases, quite linked to specific phases in the business cycle.

Finally, the investor might look at specific industries, and how the current economic, political and business landscapes may provide opportunities to enhance returns or mitigate downside risks by targeting their tactical allocations.

Equipped with a clear understanding of these three factors, we can then look to adjust our asset class and investment allocations appropriately over time. It is important to note that this would not mean that wholesale shifts of assets are made, but rather that allocations and tactical positions are adjusted thoughtfully to reflect opportunities and risks in the current view of the investment landscape.

Key Considerations in Dynamic and Tactical Asset Allocation

1. **Focus on critical drivers of asset class performance**
2. **Correctly and accurately identify the phase of the business cycle**
3. **Focus on the direction and rate of change of key indicators**
4. **Employ a practical and repeatable framework (strategy-driven approach)**
5. **Follow distinct, intermediate-term fundamental trends**

Specifics of the Three Factor Model

1. SECULAR SHIFTS

Secular factors include major elements of the global financial/ economic picture that move in cycles of more than 10 years.

Examples of a secular shift would include interest rates. From the mid-1980's to 2021, we saw more than 35 years of steadily decreasing interest rates. Arithmetically, it is impossible for that move in rates to repeat itself. As a result, we will go through a secular shift, and a different environment going forward with respect to interest rates and bond market returns.

The performance potential of certain investments is often correlated to specific points or "phase shifts" in the business cycle, allowing the informed investment manager potential opportunities.

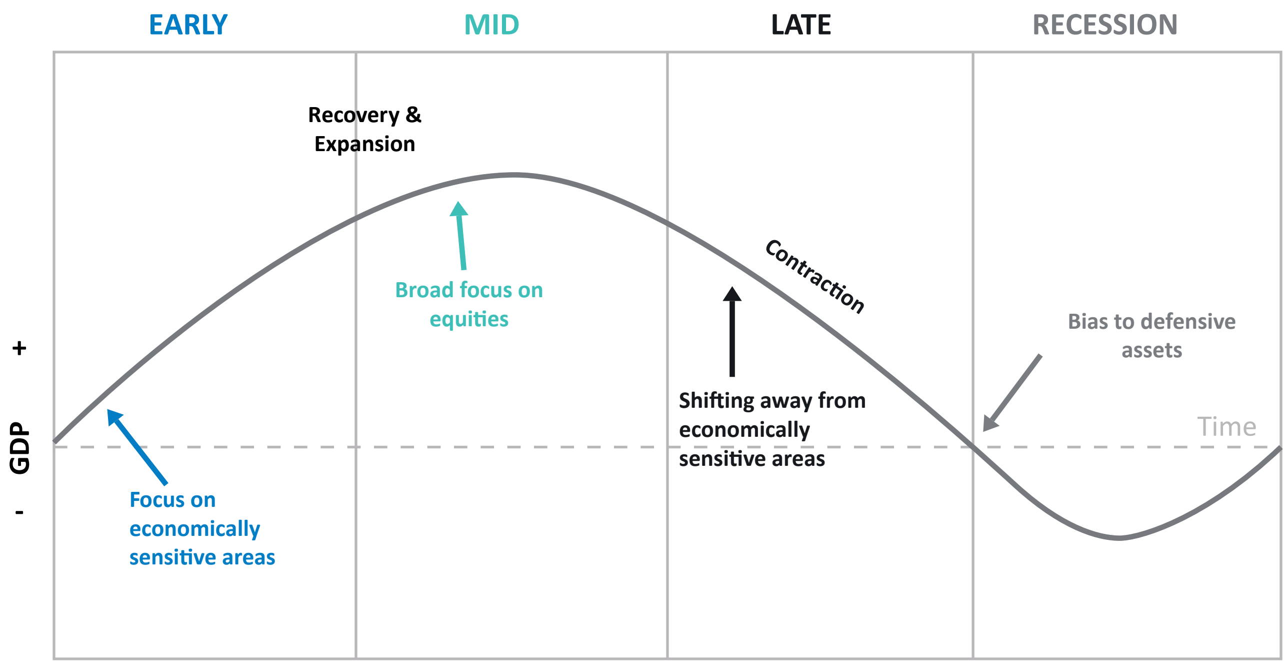
Other secular changes affecting markets may include the enormous segment of the population known as the Baby Boom generation as they move from saving and investing during their employment years to drawing on those savings as they move through their retirement years. They may consume and invest differently in retirement. This may have an impact on the markets in terms of supply and demand for different types of financial assets.

2. BUSINESS CYCLE

Business cycle changes typically occur within a one-to-ten year timeframe, with an average of just less than six years (according to the National Bureau of Economic Research). Investment opportunities or occasions to mitigate downside risk may present themselves as economies move through the phases of a cycle - from early-cycle recoveries to mid-cycle peaks, into late-cycle expansions, then to contraction/recessions, and back to recoveries.

For example, research shows that in times of economic contraction, investment grade bonds have consistently out-performed other asset classes. Conversely, in the early stages of an economic recovery, other more speculative investment classes have provided more upside leverage.

ADJUSTING EXPOSURES WITH CHANGES IN THE BUSINESS CYCLE*



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3. INDUSTRY TRENDS

Industries are subsets of market sectors. From time to time opportunities may develop to take advantage of conditions within specific industries. A manager’s knowledge of a sector and its component industries, along with careful analysis may uncover chances to target investments in a specific industry. We refer to these investments as “tactical tilts”.

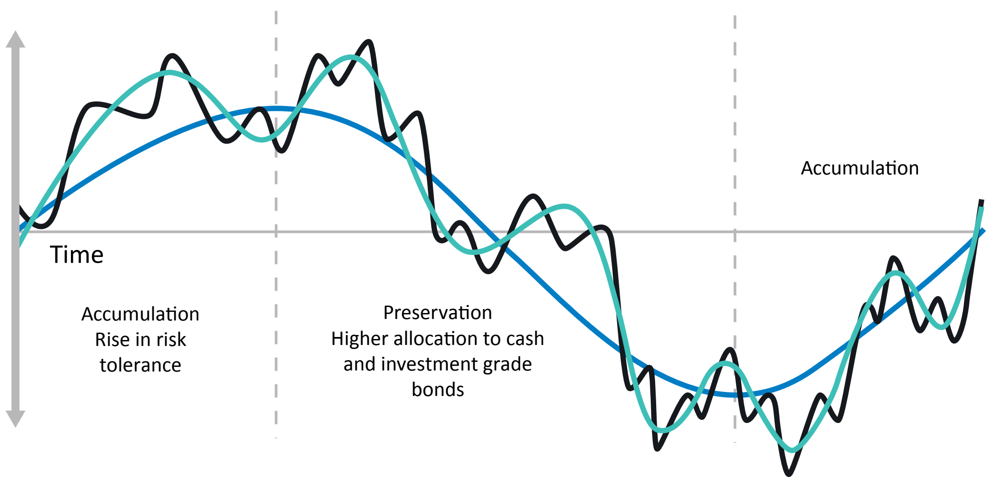
By way of a hypothetical example, an investor may believe that a particular government program affecting the healthcare sector could provide meaningful investment opportunities. With that thesis, the investor could simply invest in a healthcare sector fund as a tactical play.

However, he or she may understand that the healthcare sector is made up of a very diverse set of industry groups: managed care providers, large pharmaceuticals, small bio-technology firms, and mid-sized medical device manufacturers. There are data management companies, and on and on. The astute investor may be able to determine which of these industries will benefit most from the governmental program, and also perhaps, which may suffer. Armed with this knowledge, the investor may be able to select a targeted investment (or tactical tilts) designed to exploit those industries that will benefit most, avoiding the other relatively less attractive industries in the sector.

How does it all fit together?

DYNAMIC/TACTICAL ASSET ALLOCATION TIMELINE*

TIMEFRAMES - Secular (10+ years) Business Cycle (1-10 years) Tactical (1 month - 2 years)



Pursuing Alpha

Asset Class -- Country/Region -- Sectors -- Correlation

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While we can easily describe the asset allocation research as focusing on the critical drivers of asset class performance (the identification of secular changes, business cycle phases or industry fundamentals), it is much easier said than done. For example, correctly and accurately identifying the current phase of the business cycle, and the rate of phase shift, is critically important to portfolio construction and performance. Informed and ongoing analysis of the direction and rate of change of a myriad of key indicators, and insightful decision making are the foundation stones of this strategy.

We think that in creating a well-built portfolio, before allocating capital the investor must develop a solid intermediate-term outlook based on a deep understanding of the economic environment, secular landscape (and possible shifts), and have accurately identified where the economy sits in the business cycle. Armed with this data, an asset allocation and investment strategy appropriate to a stated risk level can be developed.

At Atlas, we employ this methodology in the management of our strategies, updating our outlook regularly to create a dynamic yet practical investment framework. While no investment discipline is able to foresee every opportunity and eliminate all risks reliably, the ability to adjust a portfolio prudently to observable changes in the investment landscape may enhance long-term performance. We believe this approach can enhance the opportunity for returns and help to reduce risks (over a static strategy such as MPT) by addressing its limitations.

Importantly, at Atlas Private Wealth Management, individual client risk tolerance, goals, objectives and specific investor instructions and restrictions provide the parameters that determine how this process is applied to individual portfolios. This investment discipline outlines the strategy we follow as we manage client assets into the future.

The material in this document is prepared for our clients and other interested parties and contains the opinions above are for illustrative purposes and example only and may not reflect actual investments in a client portfolio. Factual material is believed to be accurate, taken directly from sources believed to be reliable, including but not limited to, Federal and various state & local government documents, official financial reports, academic articles, and other public materials. However, none of the information should be relied upon without independent verification. This white paper is provided "as is" with no guarantee such an approach bases upon material discussed within this article will generate a return upon investment.

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