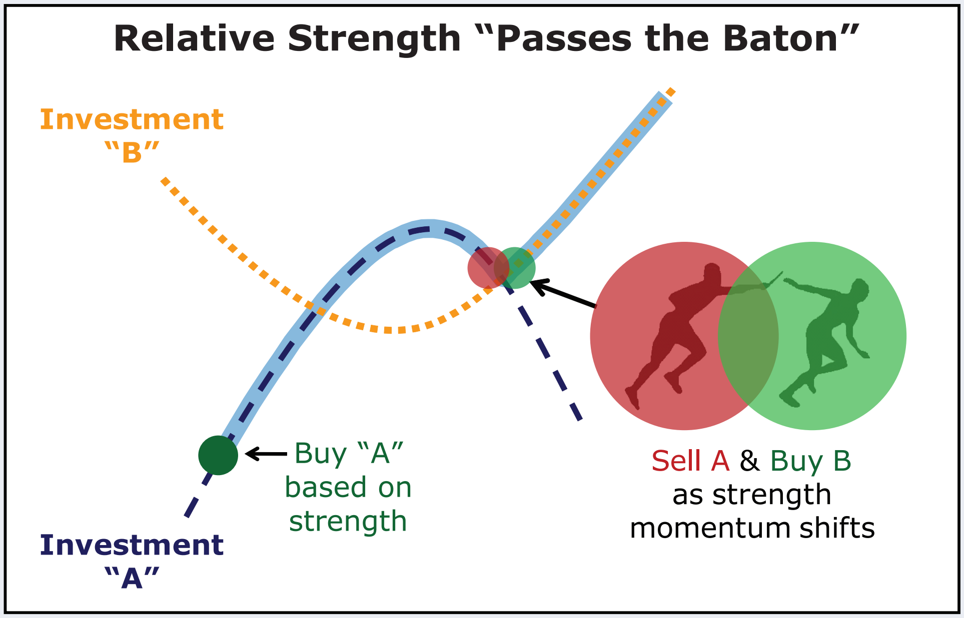
BULLSEYE Highlights

Tactical Diversification

The idea of tactical diversification seems like a contradiction in terms because the two words, tactical and diversification, have long been perceived as opposites. Diversification relies on a buy-and-hold approach based on long term averages, whereas tactical strategies tend to be adaptive and ever-changing based on shorter term data. Tactical diversification is where these two ideas intersect by turning conflicting approaches into complementary strategies. Asset class diversification has been a major tenet of portfolio structure since Modern Portfolio Theory was introduced by Harry Markowitz in the early 1950s. This philosophy is rooted in the common sense practice of not putting all of your eggs in one basket. Strategic asset allocation uses a buy-and-hold approach to diversification by looking at long-term historical risk/return data to create an optimized portfolio. This optimization process tends to look at long-term averages while ignoring short term performance swings. If an investor has a time horizon of 20 or 30 years, then they should be willing to endure the short term volatility of the markets.

Unfortunately, the philosophy of strategic asset allocation rarely aligns with the reality of an investor's emotions. Short-term swings are a reality that investors must face, making it hard to see the long-term picture. It is hard for some investors to simply ignore the fluctuations in their account values in hopes that allowing more time will solve the problem. If time were always the perfect cure, then there really would be no need for diversification. An investor could simply choose an investment with the best long-term performance history and ride out the volatility. But long-term averages can mute the reality of short-term swings. And as we all know, there is no guarantee that what has performed well in the past will continue to perform well in the future. Instead of static portfolios, some investors embrace the idea of tactical asset allocation, which involves a more adaptive approach. This should not be confused with market timing or high frequency trading. Rather, it is an active strategy which focuses on identifying what is currently working well in general and building a portfolio mix that seeks to capitalize on it. As with most investments, tactical asset allocation strategies have their periods of strength and weakness—no strategy works all the time in every market environment.

A popular tactical approach is to use a trend-following strategy such as relative strength. The idea is start with a defined universe of securities and to invest in those that are doing well relative to the others. Then, when the market changes, the portfolio moves to the investments showing strength. The strategy involves staying with winners until they start to lag, then shifting to a new investment. Momentum strategies are similar to a relay race, with periods of dips and surges. As one runner tires and slows down, pass the baton to a new runner. Momentum strategies "pass the baton" as an investment loses strength and the portfolio shifts to a new investment.



Hypothetical, for illustrative purposes only.

Many investors like a momentum-based approach because it is systematic and does not allow for a decision making process subject to speculation and emotions. But that is not to say that it always works. We all know that even the fastest runner has the potential to stumble. Relative strength strategies do have their periods of pullbacks, which is to be expected, especially as momentum shifts and market leadership changes. As a new trend is established, the portfolios must go through an adjustment period during the transition to the new areas of strength—in other words, the slow down period as the runners pass the baton. Choppy or trendless markets can also lead to periods of underperformance until new market leadership is established and a new trend develops. A pure "go anywhere" relative strength strategy may be appealing to investors with a higher risk tolerance, especially when they understand the natural ups and downs of the strategy.

Strategic diversification and tactical strategies have long been viewed as opposing philosophies. Investors have historically faced a line drawn in the sand, having to decide which side they believe in more strongly. But there is an approach which has a common middle ground—tactical diversification. By combining the common sense tenets of diversification with the practical approach of adaptability, tactical diversification seems to be at the intersection of both strategic and tactical portfolio construction. What were once perceived as conflicting approaches, when combined, may actually be quite complementary.

Consistent with Modern Portfolio Theory, a tactically diversified portfolio should rely on a blend of multiple asset classes such as stocks, bonds, commodities, and real estate (REITs). Taking a global approach, using both U.S. and international investments, may further enhance the potential for diversification. Based on historical modeling, a range of exposures may be established for each major category to allow for some flexibility. But the idea of diversification is to maintain at least some exposure to each category at all times.

Then, to allow for adaptability, a relative strength approach can be applied within each category. For example, if a portfolio is designed to maintain a constant exposure to stocks, it does not have to include all stocks. There are times when certain stocks, sectors or styles outperform. The idea is to recognize that markets are dynamic and there is a potential value in being adaptive.

Tactical Diversification:

Modern Portfolio Theory Meets Newton's Laws of Motion

Diversified strategies stem from Modern Portfolio Theory and the idea of blending multiple asset classes. **Tactical strategies**, such as relative strength, use the theory of momentum where an object in motion remains in motion until an outside force acts upon it. **Tactical diversification** relies on both theories. Harry Markowitz, meet Sir Isaac Newton.

So, how can this tactical philosophy be applied within a diversified portfolio? A tactically diversified portfolio may apply a relative strength measurement within each asset class in an attempt to identify which specific investments are currently performing the best within their market segment. On a higher level, the portfolio may also apply a second layer of relative strength at the asset class level to overweight and underweight the allocations within a predetermined minimum/maximum range. The result is a portfolio with constant exposure to a diversified set of asset classes, but with the ability to adapt to ever-changing market environments.

0565-NLD-2/7/2014