TACTICAL ALLOCATION AND THE MOVING DAILY AVERAGE

The foundation for any balanced investment portfolio is its strategic asset allocation: the proportion of stocks, bonds, cash, and everything else. These proportions are a function of the purpose and time horizon of the funds, the way the different asset prices tend to move together, and the appropriate level of risk necessary to achieve the desired outcomes. There are times, however, where it may be prudent to tilt from that strategic asset allocation. We call these temporary shifts tactical allocations.

When we first began utilizing a tactical allocation strategy in client portfolios in 2011, our motives were defensive. The signals generated tell us when we can maintain clients' higher equity allocations with greater confidence—when, in other words, the risk of greater exposure to equities is worth taking. Six years in, we're pleased with the results. This piece explains how our tactical allocation strategy works, and details the reasoning behind it.

FIRST, A LITTLE TECHNICAL BACKGROUND (BUT NOT TOO MUCH)

The tactical allocation piece in many HH portfolios can be distilled into a binary decision: Should we hold more assets in stocks right now, or not?

We implement that decision by following the Moving Daily Average (MDA) on two equity indexes, one that follows U.S. equities and one that follows international equities. For most

portfolios, this equates to holding an additional 10 percentage points more in equities than what we might otherwise, knowing that this portion, or "sleeve," will be moved to a cash alternative when the signal indicates a downtrend in those respective markets.

An MDA is made up of averaging the closing price of a security over a defined set of time—in our case, the last 200 days of index ETFs that follow the Russell 1000 (large cap US stocks), and the EAFE (large cap international stocks). Many investment managers follow and/or trade on MDA signals. Many follow, for example, the 20-day or the 50-day signal as well, but we've determined that the 200-day signal offers much of the protection of the shorter-term signals, but with less noise and thus less trading.

A good analogy might be that while we're going with the flow of traffic on the freeway, we do not have the cruise control on, and in fact, we've got our foot hovering over the brake. To expand our analogy: Instead of paring down the overall risk of the strategic allocation and moving over to the right and into the slow lane, we're fully participating in this equity rally. We're just prepared to take some risk off the table quickly should the stock markets exhibit a precipitous pullback.

THE HISTORY BEHIND IT, AND THUS THE UNDERLYING REASON

HH implemented this sleeve after investing in the technology that gives us the ability to trade several thousand accounts simultaneously. Looking back at the investment landscape in 2011, bond yields were very low. With the advent of Quantitative Easing (QE), there was a general expectation that the U.S. might be entering an environment of both strong inflation and rising interest rates – two factors that negatively impact fixed-income investors in a big way.

Well, if the outlook for bonds is poor, what about stocks? The primary issue there was that we were still under the threat of a double-dip recession. Just two years past the March 2009 bottom of the market, no one at that point was using the word "strong" to describe our recovery out of the Great Recession.

What options do you then have in your strategic allocation? You desire the potential growth of holding more stocks, but without the added risk. This is where a tactical allocation becomes an attractive solution. You want to own more stocks when their prices are rising, and hold less of them when prices are falling. Following an MDA allows you to do that within a systematic and well-established discipline.

Does it work? Yes, but not every signal change adds value. Is it perfect? No. The international equities signal helped us avoid much of a 15% decline in 2014; the U.S. signal had us exit several

weeks before the January 2016 10% correction. We call a quick in-and-out signal (or rather, out-and-in) a “whipsaw,” and we’ve had a few. The signal had us exit international stocks the week before Brexit. That ended up in a whipsaw, but all things considered, the outcome could have been much different.

The net result of this tactical allocation is that the vast majority of our clients since 2011 have held more of their portfolio in stocks than they would have otherwise. The S&P 500, for example, is up more than 100% over this same time period, and our cautious optimism has been a tremendous benefit to clients.

WHERE ARE WE NOW?

Going back more than 40 years of data, we expect the 200-day signals to come through about 1.5 times per year, but for U.S. stocks we’re approaching nearly two years without one. This is because U.S. stocks in this time period (since November 2015) have had very few directional moves besides simply going up. One outcome of this bull market may be that some of these positions may have an embedded gain that will be realized the next time the MDA signal comes through, and there may be tax implications.

This tax implication isn’t a bad thing. It means that there has been a significant positive return over the last six years – and to be quite frank, the only way to avoid paying the capital gains taxes is to die. If you’re going to spend the earnings one day, you’re going to owe the taxes.

As the signal moves in and out, the cost basis will reset and may ratchet up along the way. This should act in a way that would spread the capital gains taxes out over several time periods; it will sometimes be balanced out through tax loss harvesting. An additional consideration is that one day we may determine that for one reason or another this sleeve is better implemented with a different vehicle, and the gains would be realized then.

There are nuanced reasons why one might not want to participate in a tactical allocation strategy. One obvious reason? If you could predict when you were going to pass away, and if this were going to be soon, you’d want to wait so your heirs could get a step-up in basis. Needless to say, we recognize the difficulty in this.

Another reason would be if someone were adding significant capital to his or her account. A client in this situation would benefit from downturns in the market—essentially, she would be buying more shares for the same amount of dollars. Nevertheless, following an MDA to implement a

tactical allocation has been a prudent strategy, especially in the last six years, and we expect it to continue to be a benefit to clients in the future.

We encourage our clients to have these discussions with their advisors. While we believe that our tactical allocation is right for most clients, we want to make sure that every client understands our strategies and is disciplined to see them succeed.

RISKS AND DISCLOSURES
The views contained herein are not to be taken as an advice or recommendation to buy or sell any investment. Any forecasts, figures, opinions or investment techniques and strategies set out are for information purposes only, based on certain assumptions and current market conditions and are subject to change without previous notice.

All information presented herein is considered to be accurate at the time of writing, but no warranty of accuracy is given and no liability in respect of any error or omission is accepted.

This material should not be relied upon by you in evaluating the merits of investing in any securities or products mentioned herein. In addition, the Investor should make an independent assessment of the legal, regulatory, tax, credit, and accounting and determine, together with their own professional advisers if any of the investments mentioned herein are suitable to their personal goals. Investors should ensure that they obtain all available relevant information before making any investment.

It should be noted that the value of investments and the income from them may fluctuate in accordance with market conditions and taxation agreements and investors may not get back the full amount invested. Both past performance and yield may not be a reliable guide to future performance.

The information presented herein is for the strict use of the recipient who have requested such information and it is not for dissemination to any other third parties without the explicit consent of Halbert Hargrove.