



JULEX CAPITAL

TAA - what is it?

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TAA - what is it

What is it

Why does it work

What is it not

- Tactical asset allocation
- aka “sector rotation” although this usually implies a narrower application of TAA
- Old investment strategy . . . that’s been around for many decades

What is it

What's under the hood?

- In many ways, TAA is a passive strategy
- In the sense that . . . when properly done, it eschews
 - Forecasting
 - Prediction
 - Guesses about the future
 - Attempts to time the market

- S&P 500
- MSCI EAFE
- Bloomberg Barclays Aggregate Bond

- These are all passive indices
- But, taking the S&P as an example
 - Sometimes it has 495 stocks, sometimes 508 stocks
 - Its weights . . . change every single day
 - It's industry weightings . . . cycle through massive unprecedented swings
 - It changes with the subjective human judgements of an ever-evolving committee

- TAA, when done properly
- Is similarly passive to the S&P 500
- But it eschews subjective human judgement about what the future will bring

- Markets trend
- All markets trend
- All markets have always trended
- All this means is that a strong tendency exists for those asset categories that were trending the most
 - Strongly or favorably . . . to do so for just one more month
 - Weakly or unfavorably . . . to do so for just one more month

- It's pretty darn similar
- The average asset mix of a TAA portfolio is remarkably similar to what a static Buy&Hold investor would use for a similar level of risk
- The two . . . just don't differ that much

For example

- 30% US stocks
- 29% Int'l stocks
- 5% Treasuries
- 32% US Investment grade corporates
- 1 ½% International bonds
- 1 ½% Gold
- 1% Other commodities

- But, the TAA portfolio is adjusting to what's working . . . and what is failing
- Continually adapting so as to stay aligned/attuned with Mr. Market's current likes and dislikes
- This works unusually well during Bear Markets since these declines tend to continue for between 1 ½ to 2 years
- A similar observation can be made about Bull Markets

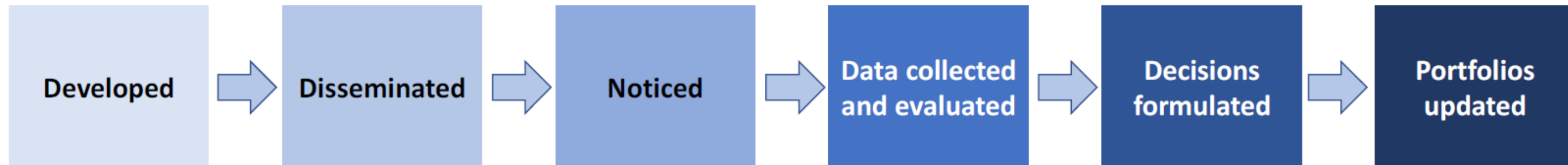
Why does it work

It is never enough to say *“Well it did work, so it will continue to work”*

- It would not work if TAA tried to do these things
 - Attempted to time market turning points
 - Forecast the future
 - Predicted the future path for interest rates, inflation, or GDP growth
 - Build its portfolio around estimates of future corporate earnings growth

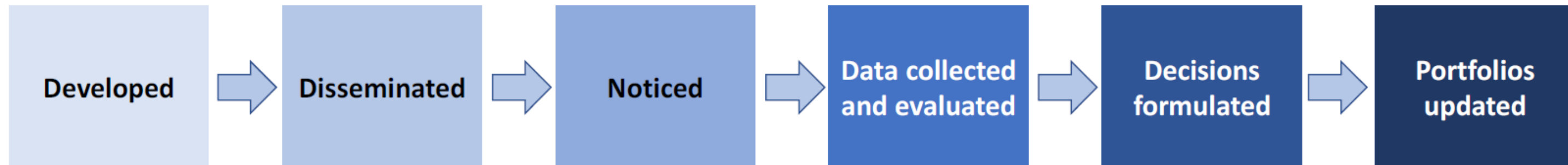
Why markets trend - Winners keep winning and losers keep losing

Investment markets trend because it takes time for new information to first develop, next be disseminated and analyzed, and finally acted upon and consequently, reflected in market prices. The length of time for this entire process varies considerably from one investor to the next and is therefore spread over many months or more.



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- It just takes time
- Information to develop
- Get noticed
- Be interpreted
- Acted upon
- Different investor types . . . operate at different speeds

What is it not

The curse of those who would over-promise and then subsequently under-deliver

What is it not? - this feels like a strange question to have to ask

- What is it not?
- Why do we even have to ask this question
- It is the curse of our industry
- Those who can't stop themselves from over-promising and then under-delivering
- TAA in particular . . . has been troubled by this dysfunction

- TAA is not an “institutional” product
- TAA is rarely offered by any investment manager with over \$500 billion of \$AUM
- Why not
- TAA is generally considered to NOT be commercially viable
 - It won't sell well
 - It won't retain assets well
- The objective of the industry is to grow i.e., gather and retain assets
- TAA is inherently at odds with the industry's objective

The industry's objective - is generally served by

- Performance that beat “the S&P” over the last 1-, 3-, and 5-years
- That’s how they gather and retain assets
- This implies something VERY important about “tracking”

A way to beat the S&P 500 - No, TAA is a poor solution

- Short-run problem
- Episodic era problem
- It's a crap shoot

- TAA turns long-term gains into short-term gains
- It is highly tax inefficient
- Although maybe not as bad as a bond
- And . . . which would you rather have
 - A loss and pay no taxes
 - A gain and pay taxes

- Pretty darn bad for 0 to 6 years
- Don't do it
- What's the problem?
- TAA's success depends on giving it enough time for the “trending phenomenon” to payoff
- Trending does not dependably payoff in the short-run . . . a year or two
- But . . . If you can give it eight, or nine, or ten years . . . the results are just brilliant

Client-facing collateral on the topic

A Pretty Good Outcome

Why doesn't BlackRock offer TAA?

Client-facing collateral on the topic

A Pretty Good Outcome . . . **very high probability of success if you give it time**

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)



A Pretty Good Outcome

Let's try a thought experiment - What if . . .

What if we build a passive portfolio from the 32 asset categories shown in the graphic below using the following weights: 30.3% US stocks, 29.3% international stocks, 5.0% US Treasury bonds, 31.5% US investment grade corporate bonds, 1.4% international bonds, 1.3% gold, and 1.2% other commodities. Over the last 102 years (ending 1/31/2021) this portfolio would have delivered 11.53% per annum. That's pretty good.

But none of us can wait for 102 years to pass. Maybe we only have 7½ years to wait. Maybe we need to spend the account 7½ years from today. What then?

Over the typical (or median) 7½ year investment time window, this portfolio returned 11.8%. But that's the typical result. Maybe you only needed to earn say 5%. If you put a blindfold on and randomly selected a 7½ year time window (from out of the last 102 years), what was your chance of earning 5% (or better), the answer is 99.9%.

Instead, maybe you needed to earn 6%, in which case the probability was 99.0%. Or 7% which resulted in 96.0% probability. Or even 7½% where the likelihood fell to 92.4%. In fact, if you only needed to earn 4.82%, then selecting a random 7½ year

A Pretty Good Outcome



So, what's the trick?

For this passive portfolio to deliver an 11.8% annualized return over the typical or median 7½ year time window (selected from out of the last 102 years), there must be a gimmick or a trick. Well, there isn't.

So, what's the rest of the story? Think about other popular passive indices, for example, the S&P 500 for US stocks, the Bloomberg Barclays Aggregate Bond for bonds, or the MSCI EAFE for international stocks. Each of these is a passive Buy&Hold index. But each also follows pre-specified rules that drive their continuous redefinition and rebalancing. For example, sometimes the S&P 500 has 495 stocks, sometimes it has 508 stocks, companies are coming and going from the index regularly, the weights

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)



of the stocks that comprise the index change every single day, and changes to the index are made using subjective judgement by an ever-evolving committee. Yet, it is a passive index.

The thought-experiment portfolio described above is also similarly passive. Although it undergoes far less change than that described above for the S&P 500 Index and whatever changes do occur are never subjective. Instead, it makes use of a simple observation, i.e., relative winners have a tendency to repeat for just one more month. And the same is true for relative losers. As a consequence, the thought-experiment portfolio heavily overweights the seven asset categories exhibiting the greatest relative trending over the last eleven months and strongly underweights (or excludes) the rest.

As a consequence, this portfolio has the average asset allocation described above, but at any instant in time, will deviate from this average so as to heavily overweight recent relative winners (and exclude or underweight the rest). The thought-experiment portfolio is continuously reshaping itself so as to remain in strong alignment with what has been working in the recent past.

What are reasonable objections?

Transactions costs erode performance - The asset categories that comprise the relative winners and relative losers generally change from month to month. Reflecting these changes entails trading and trading induces transactions costs.

Knowledgeable investment researchers have observed that failure to take these transactions costs into account will make the results look better than what could have been obtained. To correct for this problem, the results stated above assume a high level of transactions costs, ones that are overly conservative. For example, it is assumed that the one-way cost to trade a diversified package of precious metals using the most popular ETF would cost approximately 33 basis points (i.e., 0.33%).

Trust but verify - One of our nation's past presidents often used the phrase "trust but verify." This is a prudent approach when dealing with all investment strategies. Thankfully, the portfolio construction rules and the underlying data that define the thought-experiment portfolio are fully transparent and readily available. It is a simple and straightforward exercise to confirm the validity of the numbers presented above. And we will help anyone who would like to give it a try.

Next steps

Your financial advisor has a menu of possible investment solutions. The solution that is most appropriate to your unique needs and circumstances can only grow out of a meaningful discussion with your advisor. Reach out to them, talk with your advisor.

Client-facing collateral on the topic

Why doesn't BlackRock offer TAA? . . . if it's so good, then why doesn't everyone offer it

PERSPECTIVES ON TACTICAL ASSET ALLOCATION (AKA SECTOR ROTATION)



Why doesn't BlackRock offer TAA?

If TAA is so good, then why doesn't everyone offer it?

First off, BlackRock, Nationwide, Invesco, and Fidelity all offer TAA products. Nevertheless, the investment industry widely appreciates that TAA is not commercially viable, i.e., it won't sell well. How do we understand this seeming contradiction? As we explore this question, keep in mind the distinction between a product selling well in a commercial setting . . . and that same product being the best possible investment solution for an individual investor. The two have little if any overlap. Let's begin.

To address this question in a substantive fashion, we must examine a specific example, one that anyone could replicate with ease and simplicity. We'll call our specific example the thought-experiment portfolio. It's a passive portfolio built from the 31 asset categories shown in the graphic below using these weights: 33.0% US stocks, 39.4% international stocks, 8.9% US Treasury bonds, 4.2% US investment grade corporate bonds, 1.6% international bonds, 2.1% gold, and 10.8% other commodities. Over the last 102 years (ending 1/31/2021) this portfolio would have delivered 14.5% per annum. That's pretty good.

Why doesn't BlackRock offer TAA?

| | | | | | | |
|--|---|--|---|---|---|---|
| 7 U.S. stock sectors | 9 International stock sectors | 1 Industrial and agricultural commodities | 1 Inflation protection | 5 U.S. Treasury bond sectors | 4 Specialized bond sectors | 4 Precious metal sectors |
|  |  |  |  |  |  |  |
| Ranging from Industrials to Energy | Ranging from the United Kingdom to Japan | Ultra diversified industrial and agricultural commodities | Treasury Inflation-Protected Securities bonds | Ranging from very short-term U.S. Treasury bonds to ultra long-term | Ranging from liquid investment grade corporates to international bonds | Ranging from gold to palladium |

Failure to launch

The average annual return of 14.5% would seem to suggest a robust basis for stellar commercial success. But it's not. No investor can wait 102 years. Instead, there are two impediments to commercial success: (1) the short-term and (2) the occurrence of episodic eras. Let's consider each in turn.

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The short-term - in a sales setting, buyers of investment products have an unrelenting tendency to compare to the S&P 500. Worse, yet, they make this comparison over short time periods. The dysfunction of this behavior is the topic for another day. For the moment, let's just accept it as an unfortunate aspect of consumer behavior. So how does the thought-experiment portfolio perform relative to the S&P 500, in the short-run? The answer is:

| Investment time period | Probability (likelihood) of outperforming the S&P 500 Index |
|------------------------|---|
| 1 month | 54% |
| 3 months | 52% |
| 6 months | 51% |
| 1 year | 54% |
| 3 years | 63% |
| 5 years | 68% |
| 7 years | 70% |
| 7.5 years | 71% |

From a sales standpoint, from a commercial perspective, this is pretty bad. If beating the S&P 500 is the driver of incremental sales, then this investment product is DOA. But it gets worse.

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Episodic eras - We've been in a stock bull market for twelve years now. Since Feb 28, 2009, the S&P 500 has returned an average annual return of 16.9% (through Jan 31, 2021). This boom has been driven by a risk-on, emotion-driven, growth phase for technology, innovation, and clean-energy stocks. Unfortunately, the thought-experiment portfolio returned a lesser 8.8% over this same period. This gap (16.9% for the S&P versus 8.8% for the thought-experiment portfolio) ends any possible consideration for commercial success, i.e., the ability to sell a product.

But, as an individual investor, keep your own investment objectives in mind. Don't cave to the investment industry's need to make money from you . . . instead of for you. For example, if your need, your objective, was to earn at least 7% or 8% over the last twelve years, then perhaps the thought-experiment portfolio might just have been the superior solution for your needs.

But is it a best possible investment solution?

Don't get confused. Don't consider an investment through the lens of the investment industry's (quite logical, for them) lens of commercial success. The investment industry's objective is to grow, which means selling more product, i.e., gathering more assets.

Your need as an individual investor is quite different. It's to achieve your life-long financial objectives. This means earning a certain rate of return, or better. Your objective has pretty much nothing to do with beating the S&P 500 Index.

Think about this for a moment. Yes, the thought-experiment portfolio returned 14.5% over the last 102 years versus a lesser 10.3% for the S&P 500. But you don't have 102 years, none of us do.

Why doesn't BlackRock offer TAA?

Perhaps you have an investment time horizon of just 7½ years. What then? Well, the data provides an answer. If you only have 7½ years, then investing in the S&P 500 would have given you a 98% probability of earning more than **-2.4%** per annum. In contrast, the thought-experiment portfolio would have delivered a 98% probability of generating more than **+5.3%** per annum.

Which would you rather have? Which do you prefer, **-2.4%** or **+5.3%**?

Or . . . if you only have 7½ years, then investing in the S&P 500 would have provided a 95% likelihood of earning more than **-0.4%** per annum. In contrast, the thought-experiment portfolio would have given a 95% likelihood of generating more than **+6.6%** per annum.

Which would you rather have? Which do you prefer, **-0.4%** or **+6.6%**?

This comparison well highlights what might be best for you as an individual investor . . . as opposed to what might best serve the commercial interests of the investment industry. Don't let them confuse their needs for yours. Avoid the siren call from the industry's salesperson, hawking what did well over the last several years.

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