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The case for tactical asset allocation - Revisited

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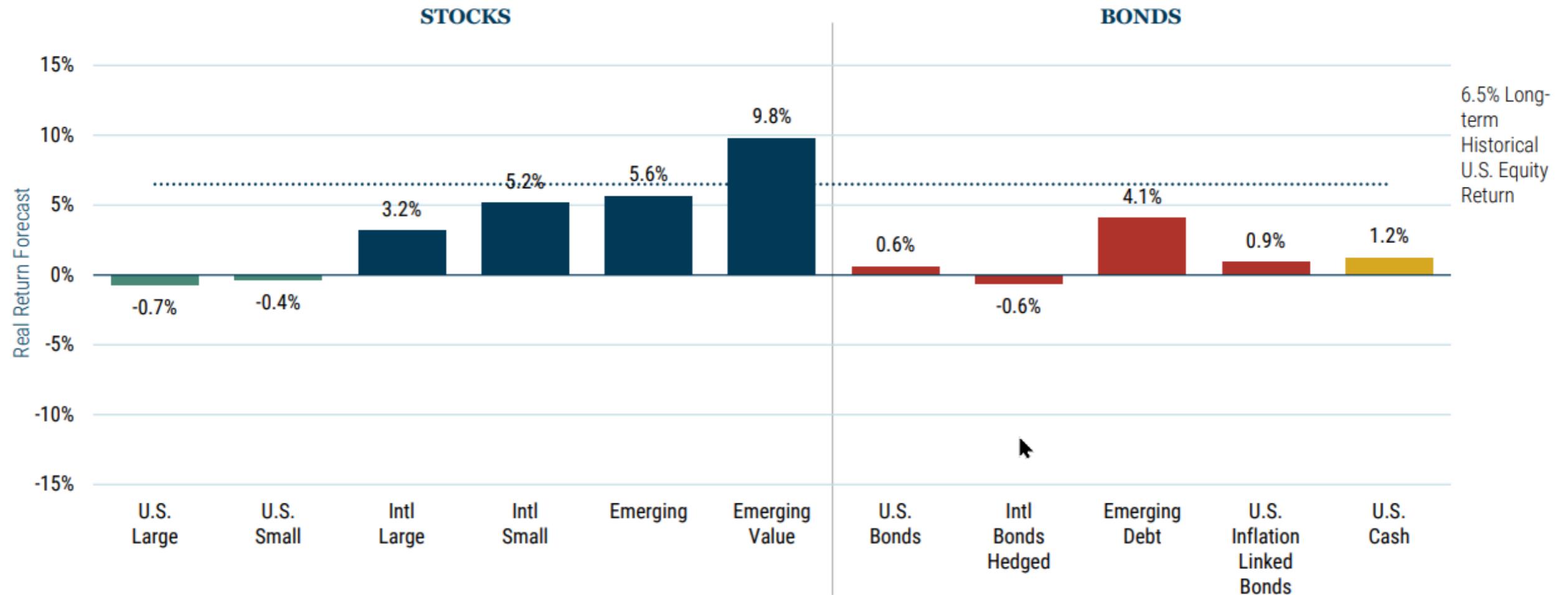
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GMO 7-Year Asset Class Forecast | January 10, 2023

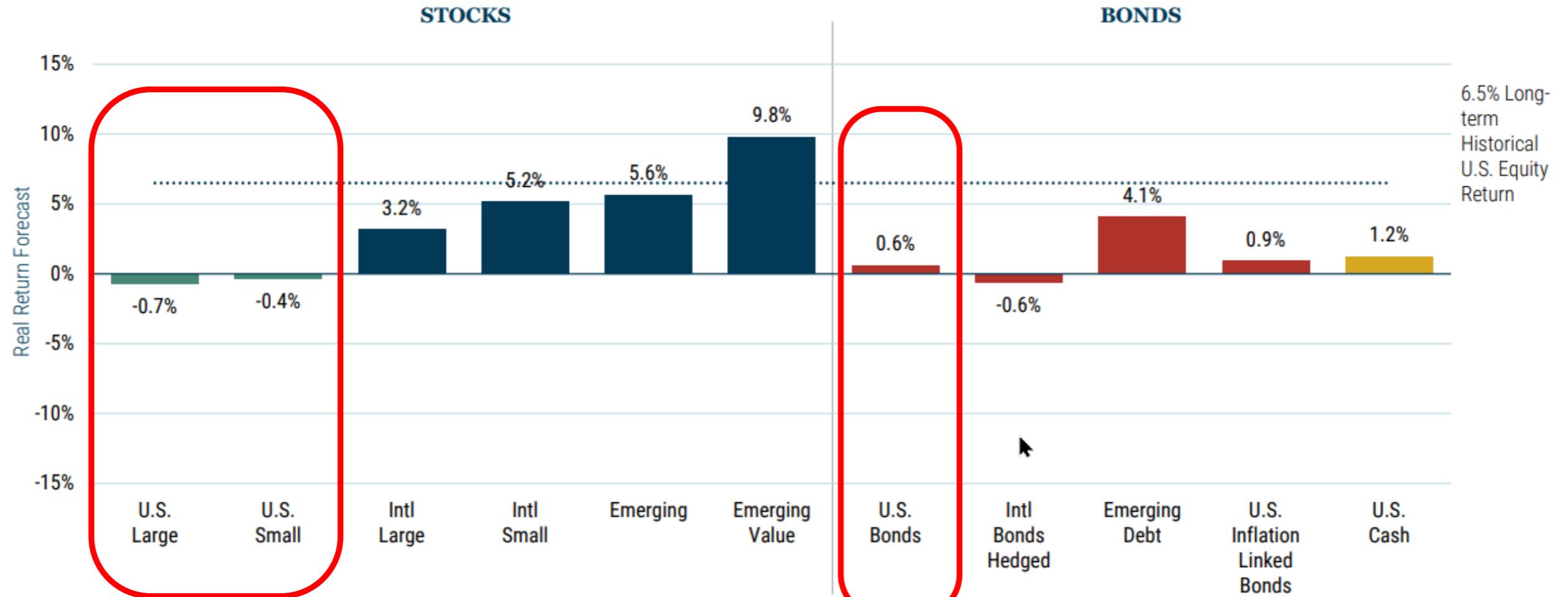## GMO 7-YEAR ASSET CLASS FORECAST: 4Q 2022

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7-YEAR ASSET CLASS REAL RETURN FORECASTS*

As of December 31, 2022

STOCKS | BONDS

Asset Class	Real Return Forecast
U.S. Large	-0.7%
U.S. Small	-0.4%
Intl Large	3.2%
Intl Small	5.2%
Emerging	5.6%
Emerging Value	9.8%
U.S. Bonds	0.6%
Intl Bonds Hedged	-0.6%
Emerging Debt	4.1%
U.S. Inflation Linked Bonds	0.9%
U.S. Cash	1.2%

6.5% Long-term Historical U.S. Equity Return

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The data

- ## 35 asset categories considered

- ## 1914 through the present
  - Multiple wars
  - Inflation, deflation
  - Banking crises
  - Terrorist acts
  - Rapid growth, stagflation
  - Numerous recessions, mild, average, severe

- ## All analysis completed after full adjustment for inflation

Primary sources of growth

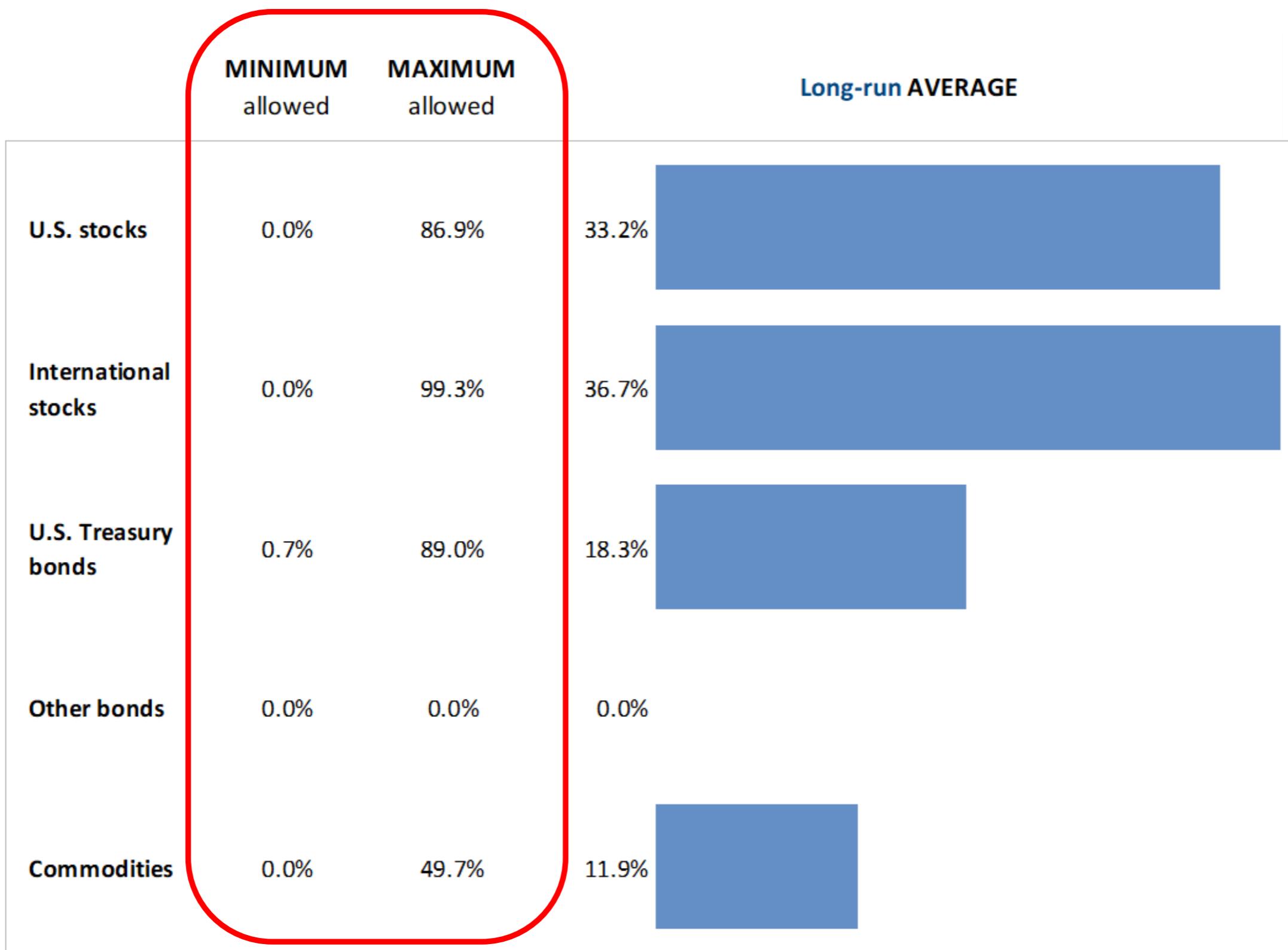| High-level asset category	Ticker symbol	Narrowly-defined asset
U.S. stocks	VNQ	Real estate
	XLE	Energy
	XLF	Finance
	XLI	Industrials
	XLK	Technology
	XLU	Utilities
	XLV	Health care
International stocks	EWA	Australia
	EWC	Canada
	EWG	Germany
	EWJ	Japan
	EWT	Taiwan
	EWU	United Kingdom
	EWY	Korea
	EWZ	Brazil
	INDA	India
	MCHI	China
Industrial and agricultural commodities	DBA	Agricultural
	DBO	Oil
	PDBC or DBC	Ultra diversified commodities

Primary sources of protection

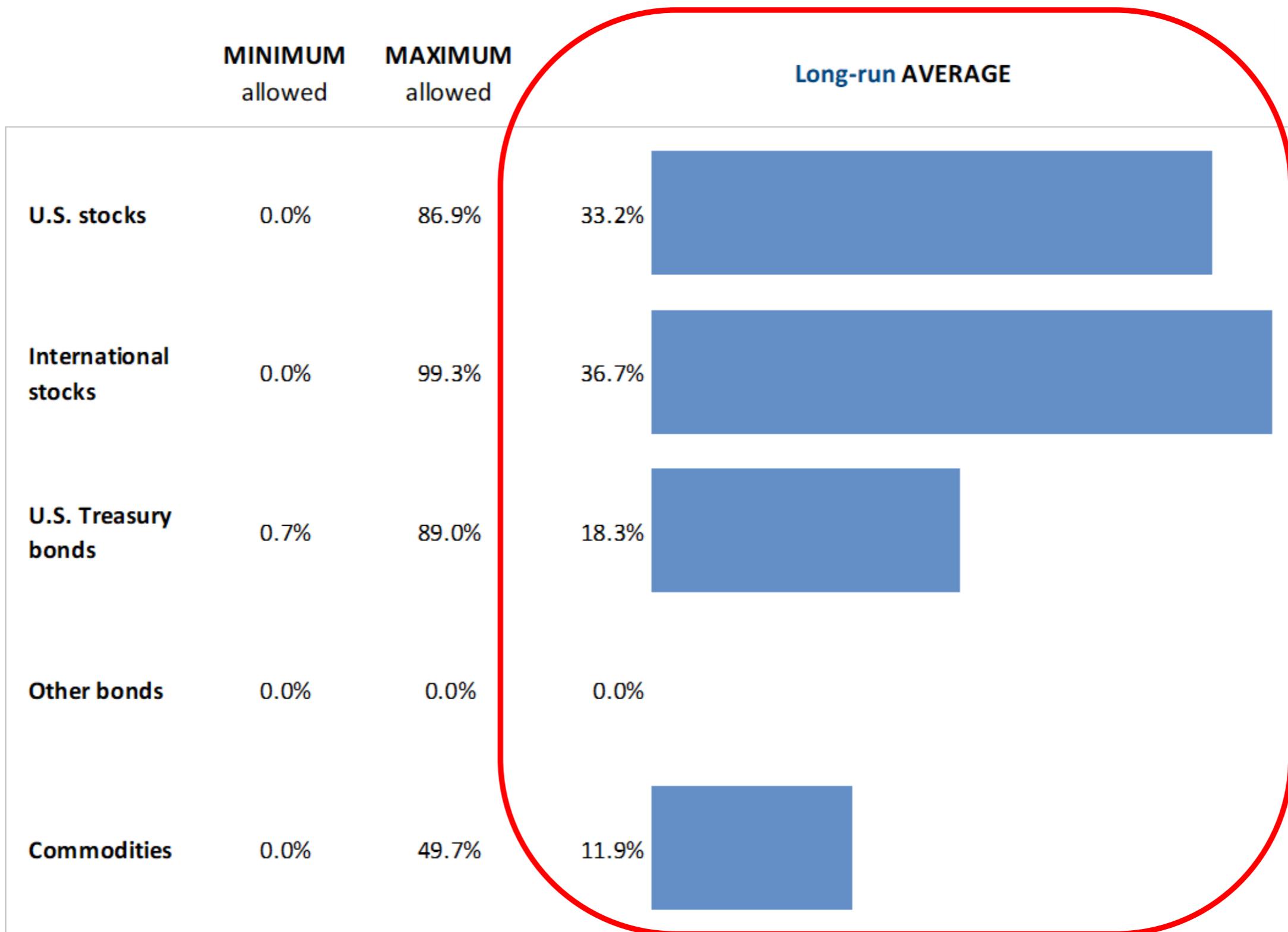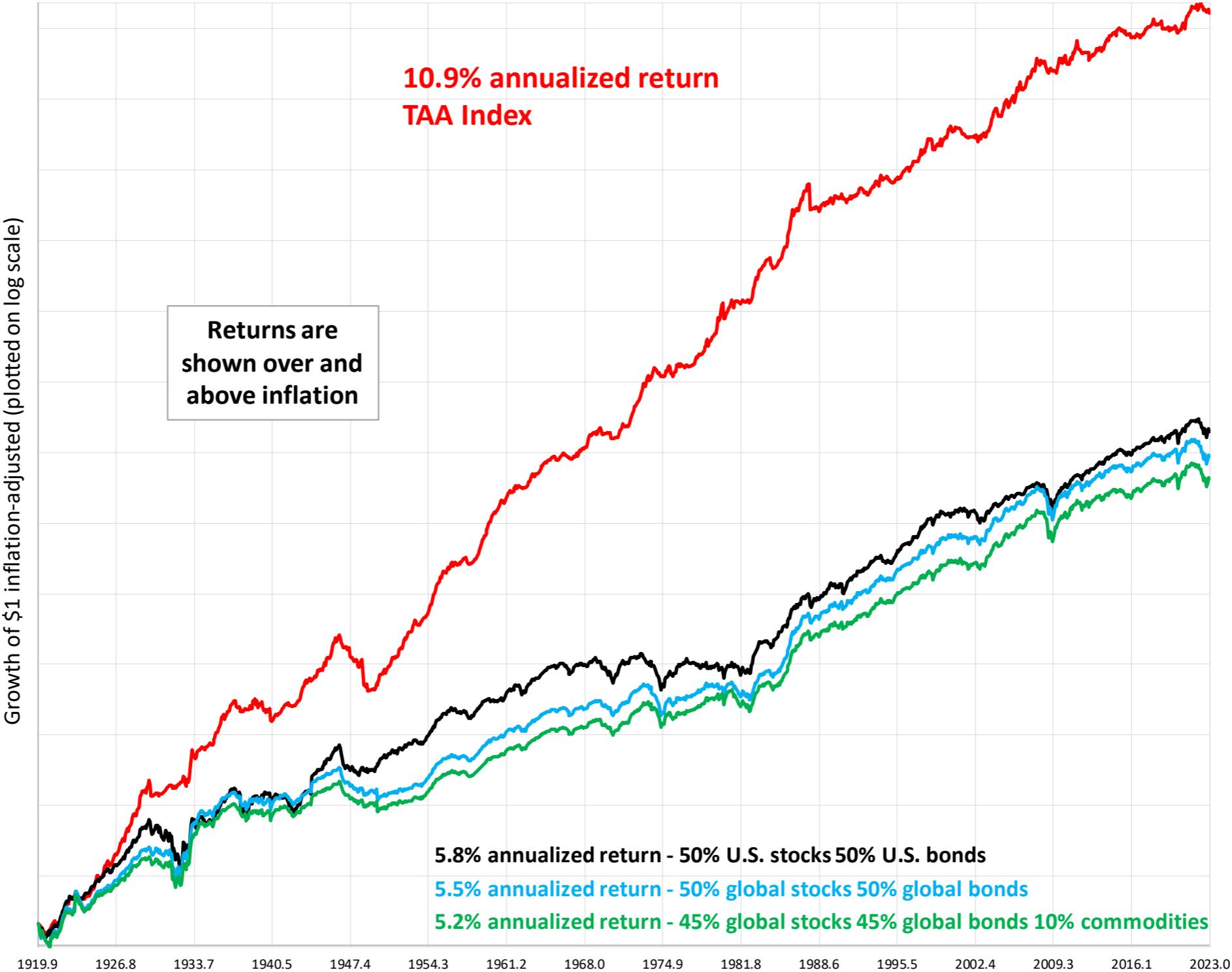| High-level asset category	Ticker symbol	Narrowly-defined asset
Investment grade U.S. bonds	IEF	7-10 year Treasury
	IEI	3-7 year Treasury
	SHV	Short-term Treasury
	TIP	Inflation protected Treasury
	TLT	20+ year Treasury
	VCIT	Intermediate investment grade corp
	ZROZ	Ultra long-term Treasury
Junk bonds	HYG	High yield bonds
Precious metals	GDX	Gold mining company common stocks
	GLD	Gold
	GLTR	Ultra diversified precious metals
	PALL	Palladium
	PPLT	Platinum
	SLV	Silver
Int'l bonds	EMLC	Local currency emerging country bonds

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- Eight asset categories that trended the most strongly over the last 11 months

- Equal-weighted

- However . . . . Cash (90-Day Treasury Bills) are allowed to take a significant over-weight

- Unique client requirements
  - Investment time horizon of 14.9 years
  - Cash not allowed to exceed 61.4% of the portfolio . . . . for reasons of humility

	MINIMUM allowed	MAXIMUM allowed	Long-run AVERAGE	
U.S. stocks	0.0%	86.9%	33.2%	
International stocks	0.0%	99.3%	36.7%	
U.S. Treasury bonds	0.7%	89.0%	18.3%	
Other bonds	0.0%	0.0%	0.0%	
Commodities	0.0%	49.7%	11.9%	

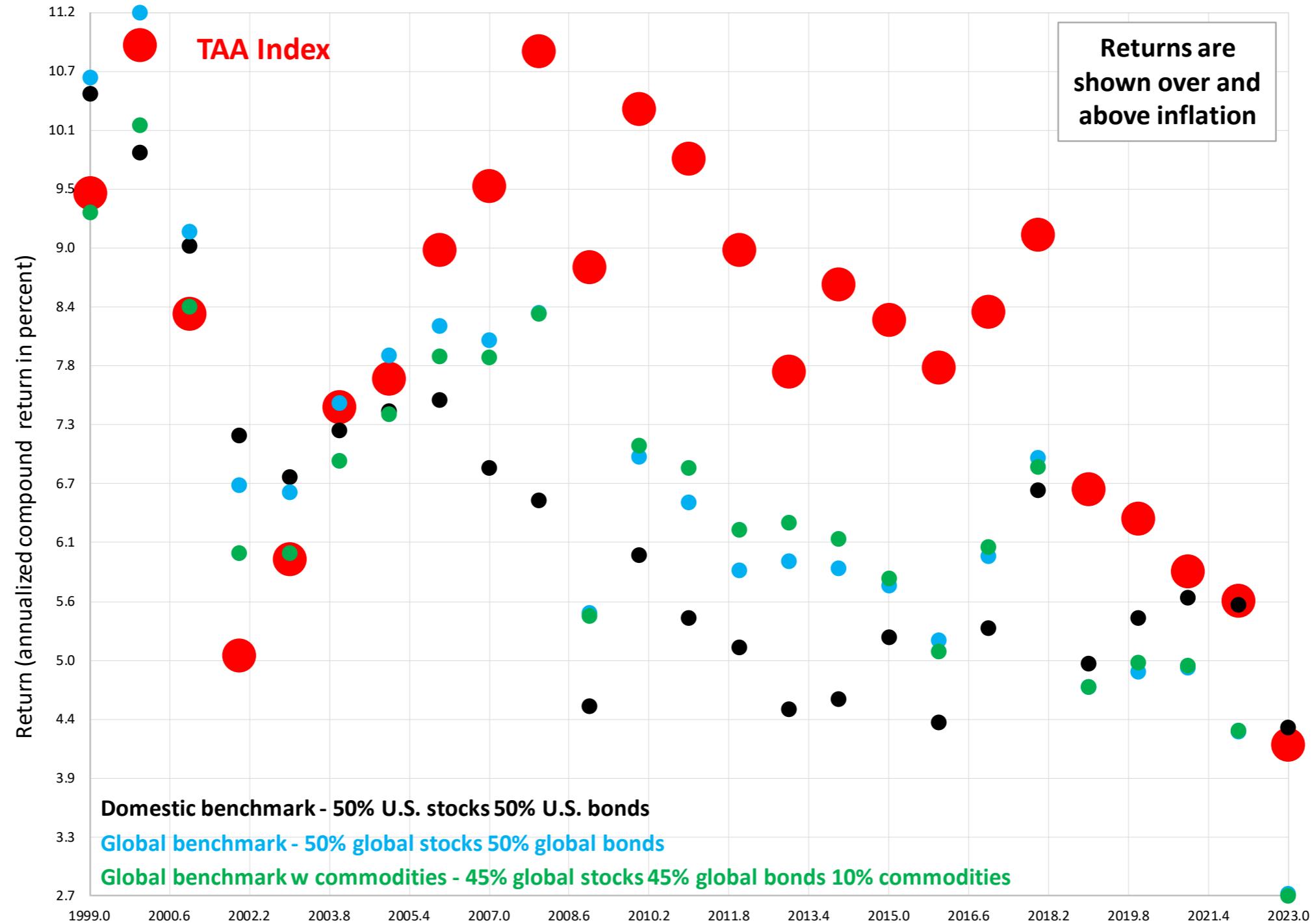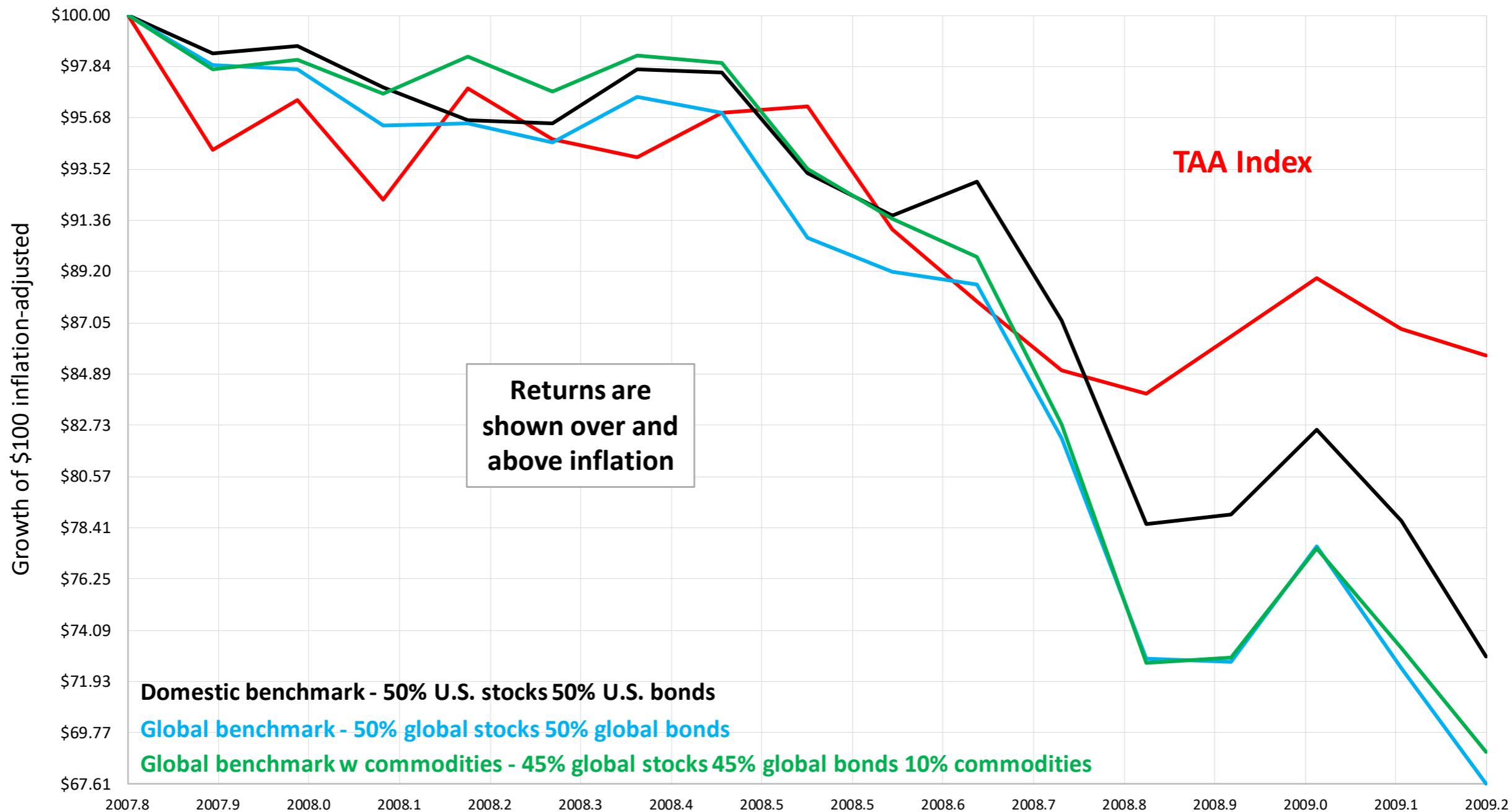|	MINIMUM allowed	MAXIMUM allowed	Long-run AVERAGE	
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Large and consistent outperformance over the long-run

**10.9% annualized return
TAA Index**

Returns are
shown over and
above inflation

Growth of $1 inflation-adjusted (plotted on log scale)

5.8% annualized return - 50% U.S. stocks 50% U.S. bonds

5.5% annualized return - 50% global stocks 50% global bonds

5.2% annualized return - 45% global stocks 45% global bonds 10% commodities

1919.9   1926.8   1933.7   1940.5   1947.4   1954.3   1961.2   1968.0   1974.9   1981.8   1988.6   1995.5   2002.4   2009.3   2016.1   2023.0
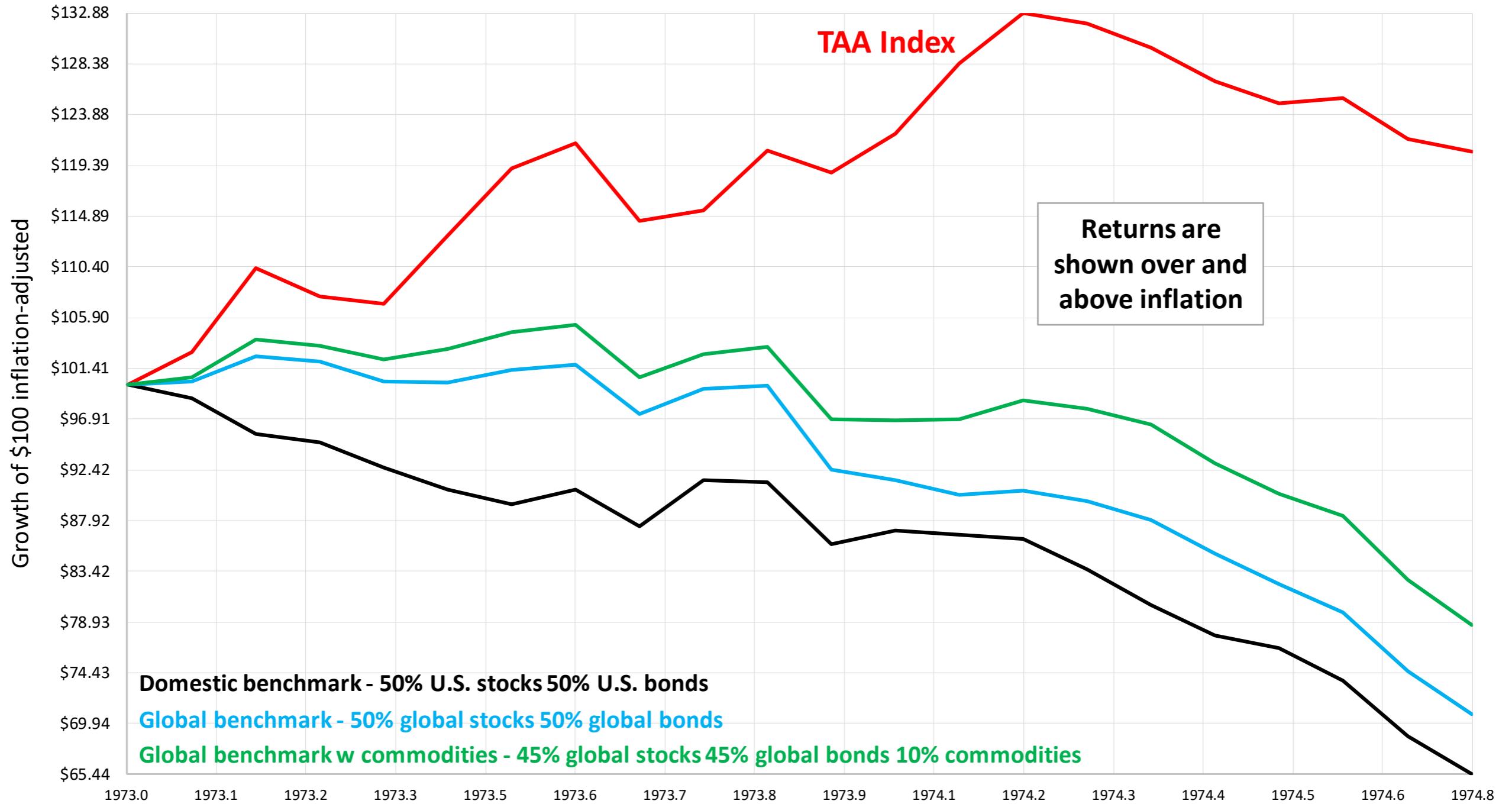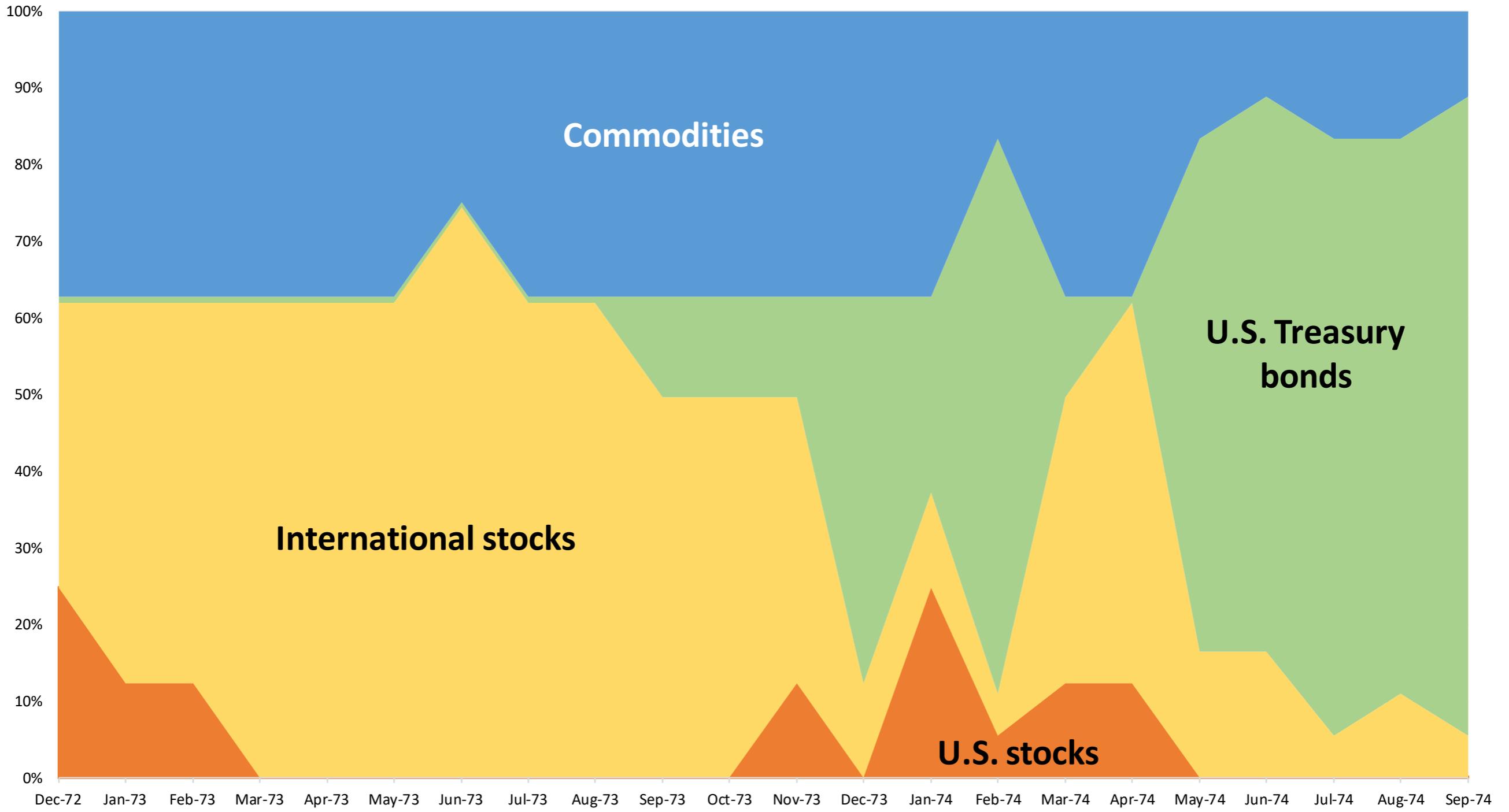
Outperformance over almost all 14.9-year investment periods

TAA Index

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Global benchmark - 50% global stocks 50% global bonds
Global benchmark w commodities - 45% global stocks 45% global bonds 10% commodities

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TAA Index

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Growth of $100 inflation-adjusted

TAA Index

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Growth of $100 inflation-adjusted

Returns are shown over and above inflation

TAA Index

Domestic benchmark - 50% U.S. stocks 50% U.S. bonds

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In or out	Ticker	Asset type	Trending/momentum score	
✓	XLF	Finance		4.30
✓	XLI	Industrial		6.87
✗	XLU	Utility		1.17
✗	XLV	Health care		3.06
✗	XLK	Technology		-5.74
✗	VNQ	Real estate		-7.02
✓	XLE	Energy		10.64
✓	MCHI	China		9.73
✗	EWZ	Brazil		0.28
✗	EWJ	Japan		0.27
✓	EWG	Germany		10.90
✗	EWY	South Korea		2.47
✗	EWT	Taiwan		-2.11
✓	EWU	United Kingdom		5.85
✗	EWC	Canada		-4.35
✗	INDA	India		-0.34
✓	EWA	Australia		3.45
✗	SHV	Ultra short term Treasuries		0.88
✗	TLT	Long term Treasuries		-6.19
✗	IEF	7-10 year Treasuries		-1.86
✗	IEI	3-7 year Treasuries		-0.75
✗	ZROZ	Ultra long term Treasuries		-10.61
✗	TIP	Inflation protected Treasuries		-3.13
✗	VCIT	Intermediate term IG corporate bonds		0.05
✗	HYG	High yield bonds		1.48
✓	EMLC	Local currency emerging country bonds		3.80
✓	GDX	Gold mining company stocks		6.16
✓	SLV	Silver		7.13
✗	GLD	Gold		3.11
✗	PALL	Palladium		-18.25
✓	PPLT	Platinum		9.75
✗	GLTR	Diversified precious metals		1.58
✗	PDBC	Ultra diversified commodities		-7.15
✗	DBA	Agricultural commodities		-6.34
✗	DBO	Oil		-13.72

Date	Optimistic, neutral, or pessimistic	Portfolio's optimism/pessimism score
4/10/2022	✓	79.6
5/10/2022	!	60.7
6/10/2022	!	61.3
7/10/2022	!	37.7
8/10/2022	!	60.2
9/10/2022	✓	67.5
10/10/2022	!	61.3
11/10/2022	!	63.4
12/10/2022	!	63.4
1/9/2023	✓	85.1

Scores range from 0.0 to 100.0 (most pessimistic to most optimistic)

US stocks   Intl stocks   Treasury   Other bonds   Commodity
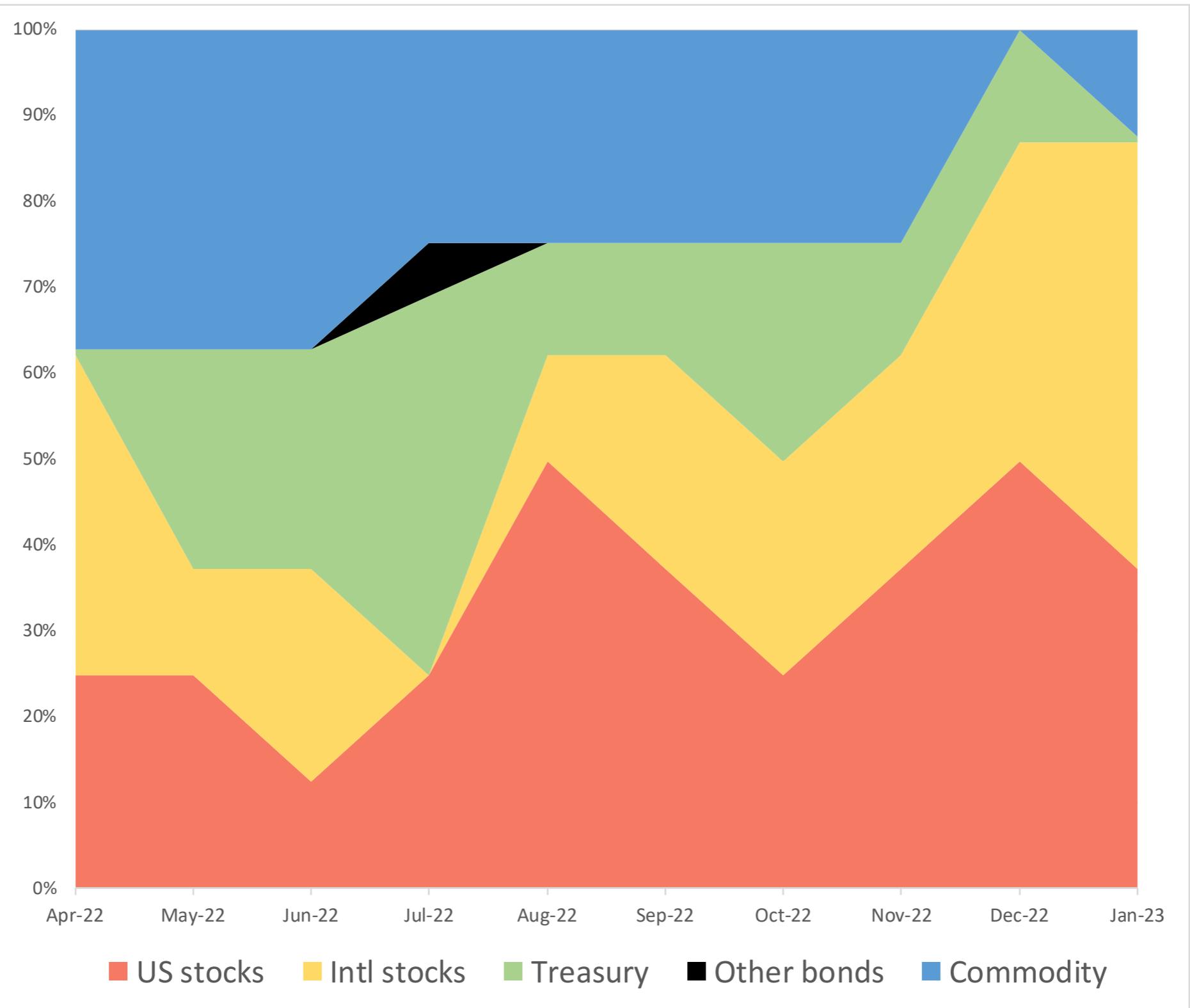
XLF		12.41
XLI		12.41
XLE		12.41
MCHI		12.41
EWG		12.41
EWU		12.41
EWA		12.41
SLV		12.41
JSTODIAL_CASH		0.72

Objections

It's based on predictions or forecasts . . . . which could be wrong

- NO it is not

- It is never based on any forecasts of the future
- Instead, it relies on an extremely simple look-back rule
- One that any high-school graduate could replicate

- Success relies on the observation that all markets trend . . . have momentum
  - Winners repeat
  - Losers repeat

- Often . . . the most successful investment strategies are the simplest

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- NO . . . I did not

- It is based on an extremely simple rule
  - Just select the 8 asset classes that trended the most strongly over the last 11 months
  - That's it

- Yes . . . cash is weighted as based on the investment time horizon, but not its selection . . . .
  - And those weightings never vary over time
  - It's just like when you build a passive index portfolio yourself

- NO . . . I did not

- The returns were calculated by Global Financial Data, Inc.
- And not by me

- OK

- [Here are two](#) fully independent verifications

- Both of them are extremely heavily peer reviewed . . . .
- And got published after having passed the highest possible bars for integrity and rigor

A Century of Evidence on Trend-Following Investing

BRIAN HURST, YAO HUA OOI, AND LASSE HEJE PEDERSEN

WINNERS REPEAT, LOSERS REPEAT

ROB BROWN

Winners Repeat, Losers Repeat

Rob Brown

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KEY FINDINGS

- The TAA portfolio earned an inflation-adjusted 10.8% over the aggregate period (102.1 years), whereas a comparable passive index earned a lesser 6.7% (one with a similar standard deviation, a 75/25 global stock/bond mix).

- TAA's performance advantage resulted even after subtracting unusually high transaction costs from the TAA portfolio, while assuming that the comparable passive index could rebalance each month cost-free.

- The TAA portfolio's greater relative success in achieving the stated investment objective did not diminish with the passage of time. If anything, it may have improved during the most recent period (14.3% of the cases examined drawn from the data spanning 1919–2021).

ABSTRACT

I present a tactical asset allocation proof-of-concept portfolio. It is intended to harvest the non-IID statistical attributes of stocks, bonds, commodities, and currencies, both domestic and international. It has as its objective to benefit from markets' propensity to trend from month to month and during both bull and bear market environments. The proof-of-concept portfolio relies on a simple quantitative rule that allows for rigorous evaluation over the past 102.1 years. The results presented herein suggest that Tactical Asset Allocation (TAA) is an approach worthy of consideration. Moreover, the article suggests that a necessary condition for TAA success lies in correctly specifying its rather differentiated investment objective— one that may be unrelated to comparisons with popular fixed-weight index benchmarks. Such fixed-weight benchmarks have correlations with TAA strategies that are so low as to make commonly used statistical comparisons irrelevant (i.e., not statistically significant). This article attempts to correct our industry's mischaracterization and overpromising of all things TAA by focusing on the time required for success.
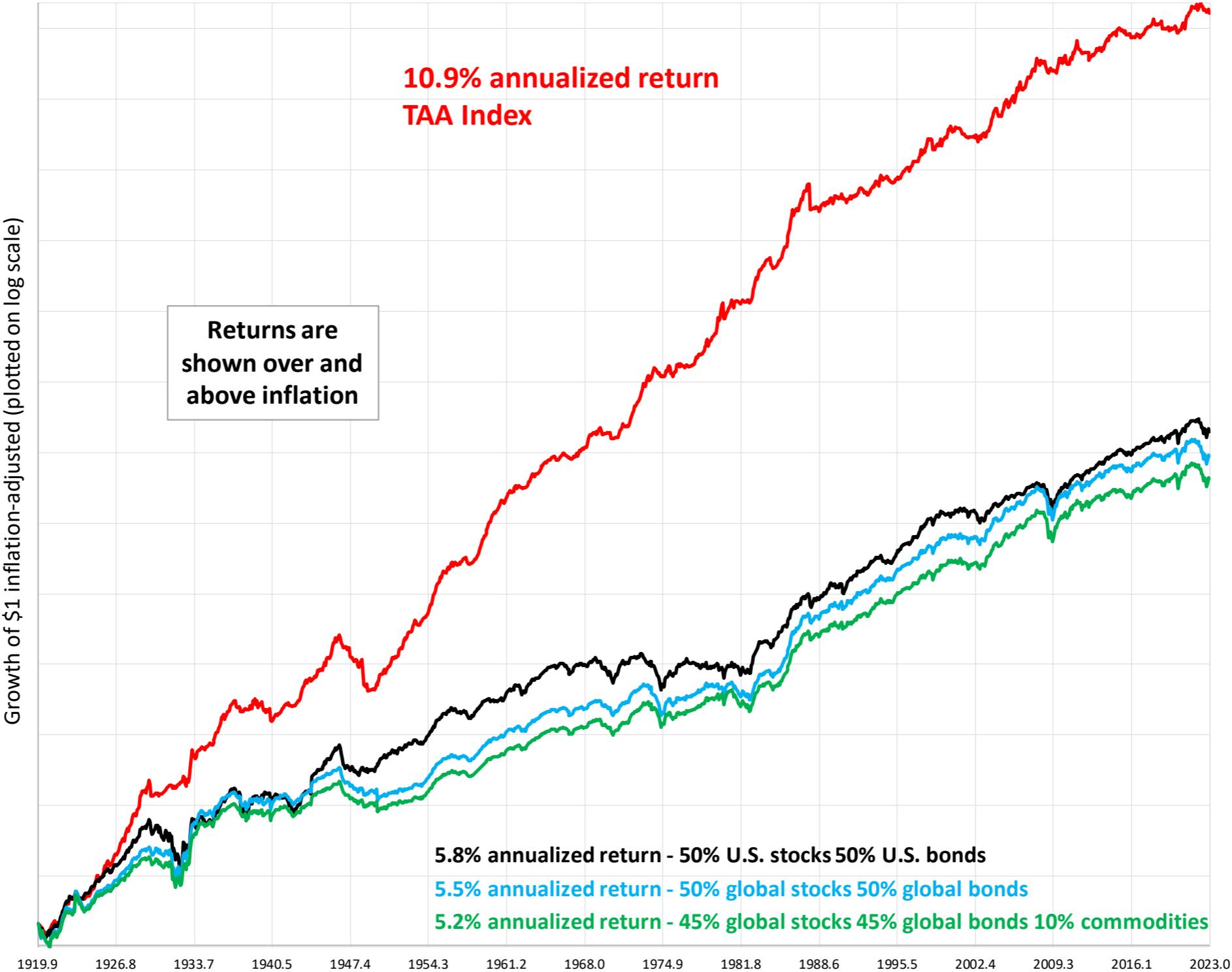
Tactical Asset Allocation (TAA) earned a poor reputation over the past 13 years (since 3/6/2009, the recent bear market low). My objective is to mitigate a portion of the retail industry's TAA skepticism. This is an interesting topic, given the size of the retail industry, TAA's prominence within it, and forecasted future growth in TAA's market share. Direct and indirect, the retail industry is large and growing, currently estimated to be more than $16 trillion.[1] TAA first came into existence back in the 1980s and has grown consistently ever since, with occasional faster growth

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[1] Sources: ICMA (International Capital Market Association) analysis using Bloomberg Data (August 2020), Ned Davis Research, and The Visual Capitalist (https://www.visualcapitalist.com).
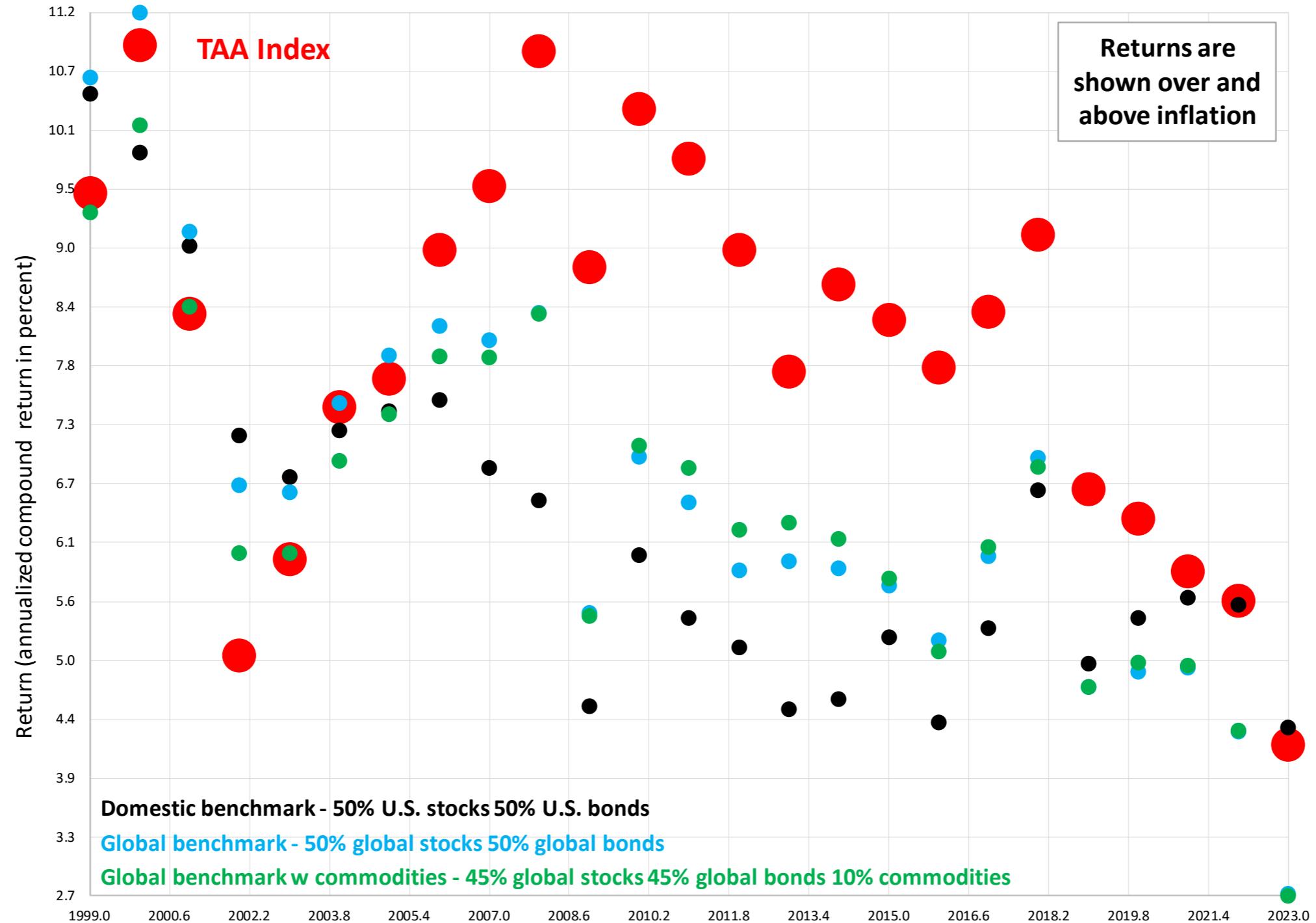
- <u>NO</u> . . . . that is just plan wrong
- Such a conclusion is <u>not</u> supported by the data

- The simple model presented herein adopts an investment time horizon of 14.9 years

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My favorite Julex tactical asset allocation model

- Dynamic series

- Can go 100% back to "cash"

- International and U.S. are rebalanced at separate points, once each month

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How to access international - But without getting burned

Friday

February 10th

11:00 a.m. EASTERN

All data and statistics were provided by Global Financial Data, Inc. and NDR, Inc. (unless otherwise indicated in the exhibit)

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Some part of the investment performance shown is HYPOTHETICAL. It is based on the back tests of historical data. Hypothetical performance results have many inherent limitations, some of which are described below. No representation is being made that any account will or is likely to achieve profits or losses similar to those shown. In fact, there are frequently sharp differences between hypothetical performance results and the actual results subsequently achieved by any particular trading program.

One of the limitations of hypothetical performance results is that they are generally prepared with the benefit of hindsight. In addition, hypothetical trading does not involve financial risk, and no hypothetical trading record can completely account for the impact of financial risk in actual trading. For example, the ability to withstand losses or adhere to a particular trading program in spite of trading losses are material points which can also adversely affect actual trading results. There are numerous other factors related to the markets in general or to the implementation of any specific trading program which cannot be fully accounted for in the presentation of hypothetical performance results and all of which can adversely affect actual trading results.

The composition of a benchmark index may not reflect the manner in which a Julex portfolio is constructed in relation to expected or achieved returns, investment holdings, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility, or tracking error targets, all of which are subject to change over time.

No representation or warranty is made to the reasonableness of the assumptions made or that all assumptions used to construct the performance provided have been stated or fully considered.