DRS vs. Market Timers and Tactical Asset Allocators

Compare and Contrast Strategies

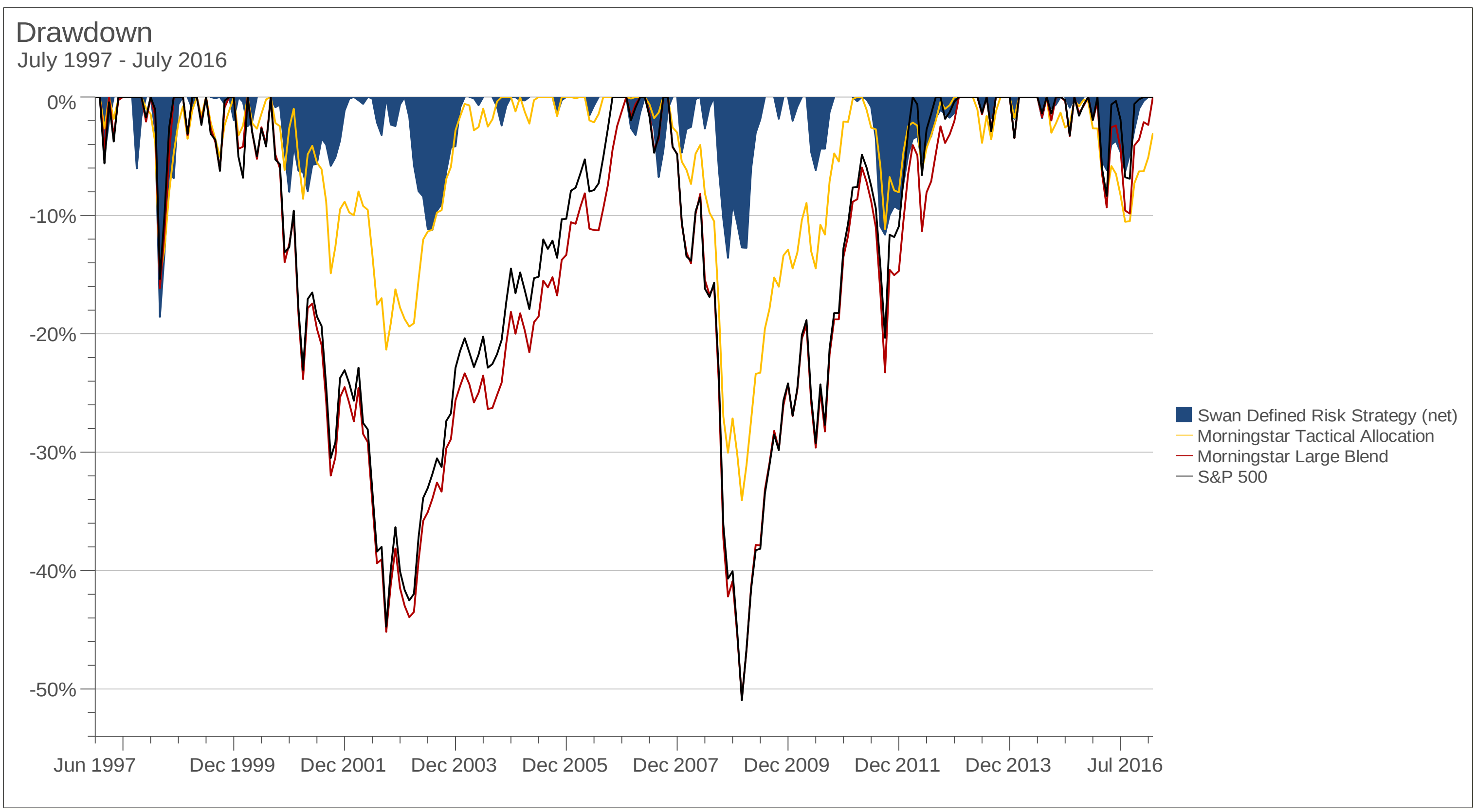
[Marc Odo](), CFA®, CAIA®, CIPM®, CFP® | Jan 28, 2016 | [Swan Blog]()

An Apple in an Orange Bin

At Swan Global Investments, we are frequently asked "In which category do you belong?" or "Who are your competitors?" We believe that the Defined Risk Strategy is a rather unique solution, and no one is currently doing what we are doing. The DRS doesn't fit nicely into a predefined box.

That said, it is inevitable that the DRS gets compared against other managed products. This post will be the first in a series where we compare and contrast the DRS against other types of investment strategies. Because we are most frequently compared to tactical asset allocators or market-timing strategies, this is where we will start.

The one and only thing that the DRS has in common with tactical asset allocators is an aversion to down markets. Passive strategies or stock-pickers who hew closely to a benchmark will track their benchmarks on both the upside and the downside. If the market has a major sell-off, stock pickers typically offer little downside protection, and passive strategies offer none. Both the Defined Risk Strategy and most tactical asset allocators attempt to actively minimize exposure to down markets.



Source: Zephyr StyleADVISOR

However, the manner in which tactical asset allocators (TAA) and the DRS attempts to accomplish this goal couldn't be more different. The typical tactical asset allocator's value proposition is based upon market timing. A TAA strategy will typically make significant, top-down changes to their strategy's asset allocation based upon changing forecasts on the marketplace or some sort of indicator based on past historical occurrences. A simplified description of a tactical asset allocator's philosophy might be, "The best way to not lose money is to avoid the asset classes with the worst performance." Moreover, the opportunity set of a TAA strategy is usually very broad. Unlike a large cap stock picker that can only choose from a field of 500 or 1,000 stocks, the opportunity set for a TAA strategy is much broader.

2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Emg Mkt 32.6%v	Emg Mkt 39.8%v	Long Treasuries 33.7%	Emg Mkt 79.0%	Gold 29.2%	Long Treasuries 33.8%	Emg Mkt 18.6%	US Small Cap 38.8%	Long Treasuries 27.5%	US Large Cap 1.4%
For Dev 26.9%	Gold 31.9%	Gold 4.3%	For Dev 32.5%	US Small Cap 26.9%	Gold 8.9%	For Dev 17.9%	US Large Cap 32.4%	US Large Cap 13.7%	For Dev -0.4%
Gold 23.2%	For Dev 11.6%	US Small Cap -33.8%	US Small Cap 27.2%	Emg Mkt 19.2%	US Large Cap 2.1%	US Small Cap 16.3%	For Dev 23.3%	US Small Cap 4.9%	Long Treasuries -1.6%
US Small Cap 18.4%	Long Treasuries 10.2%	US Large Cap -37.0%	US Large Cap 26.5%	US Large Cap 15.1%	US Small Cap -4.2%	US Large Cap 16.0%	Emg Mkt -2.3%	Gold 0.1%	US Small Cap -4.4%
US Large Cap 15.8%	US Large Cap 5.5%	For Dev -43.1%	Gold 25.0%	Long Treasuries 9.4%	For Dev -11.7%	Gold 8.3%	Long Treasuries -13.9%	Emg Mkt -1.8%	Gold -12.1%
Long Treasuries 0.9%	US Small Cap -1.6%	Emg Mkt -53.2%	Long Treasuries -21.4%	For Dev 8.2%	Emg Mkt -18.2%	Long Treasuries 3.4%	Gold -27.3%	For Dev -4.5%	Emg Mkt -14.6%

Emerging Markets
Foreign Developed Markets
Gold
U.S. Small Cap Stocks
U.S. Large Cap Stocks
Long U.S. Treasuries

Source: Morningstar Direct

In theory this is a good way to minimize losses. As the table above illustrates, there can be wide dispersions between the best and worst performing asset classes. With a wide-open mandate, a tactical asset allocator could have many more asset classes to choose from.

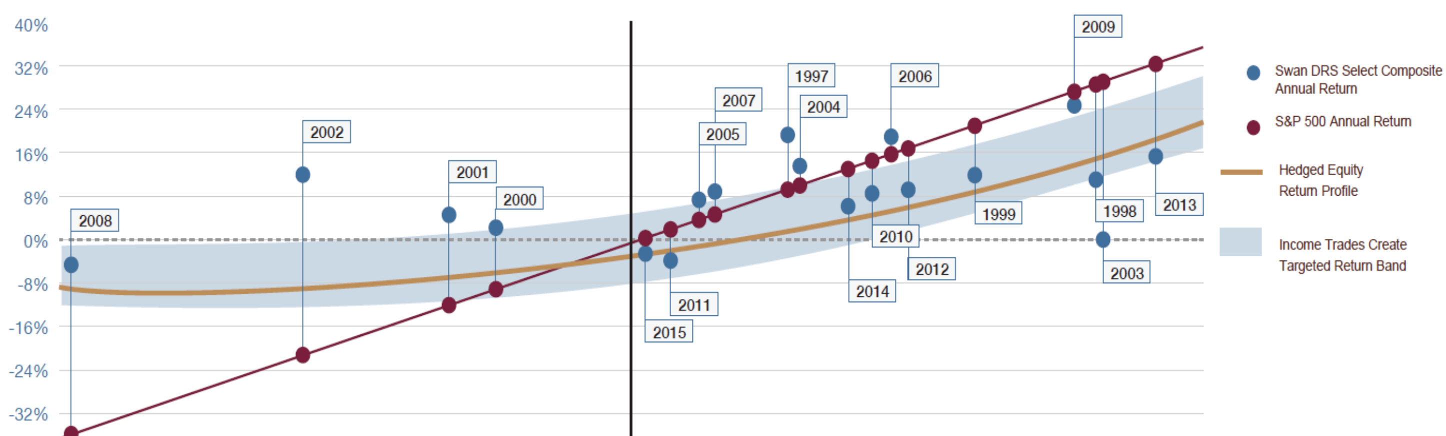
However, the whole trick to being a successful tactical asset allocator is being in the right place at the right time. It's just as easy to be caught out on the wrong side of the tracks. If a TAA gets their market calls wrong, the potential for underperformance is every bit as great as the potential for outperformance. The investment landscape is littered with TAA strategies whose "Midas Touch" eventually deserted them, leaving them well behind the market. I like to sum up the experience of TAA strategies as "live by the sword, die by the sword."

At Swan Global Investments we believe it is very difficult if not impossible to always be one step ahead of the market, as required by a market-timing strategy.

It’s inevitable that any given TAA strategy will have some of their market timing calls work out in their favor and some will go against them, but we do not believe market-timing to be a sustainable long-term strategy.

Swan’s investment motto is “Always invested, always hedged.” We do not profess to know when markets will go up or go down. We remain always invested with a buy-and-hold position in a given market, in order to capture as much of the upside as we can. However, we never know when steep sell-offs might occur, so we always maintain a hedge to protect our assets against bear markets. We always maintain this hedged equity approach. I like to say it doesn’t matter if the markets are down 50% like they were during the Financial Crisis or if the market is in an eighth year of a bull market- the Defined Risk Strategy is always doing the same thing.

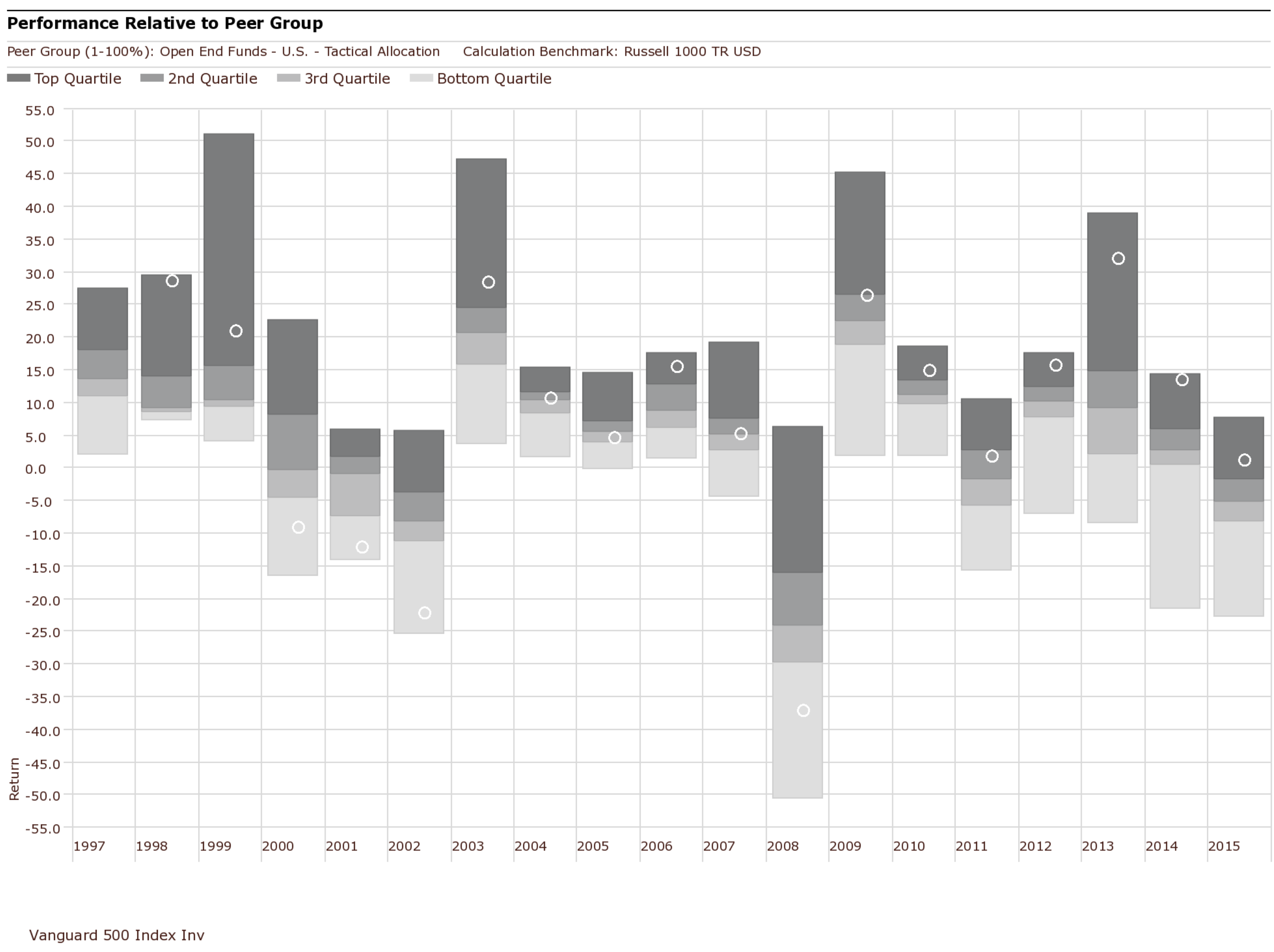
Because Swan follows a very systematic approach, we can estimate with a fair degree of accuracy where our returns might fall in any given year, something that market-timers cannot do. The chart below is one we use frequently at Swan. The diagonal red line is the profit-loss diagram for the S&P 500. The curved gold line represents the return profile of our hedged equity position, that is, our buy-and-hold position in the market combined with the protective elements of our hedge. The gold line lags the S&P 500 in up markets but is still upward sloping. In down markets the hedged equity position’s losses flatten out as the S&P 500 continue to drop.



Source: Swan Global Investments

The blue area around the gold curve is the anticipated impact of overlaying Swan’s short-term premium collection trades over the hedged equity position. It is our expectation that returns of the DRS will be within or above the blue shaded area. In 17 of 18 years, they have been.

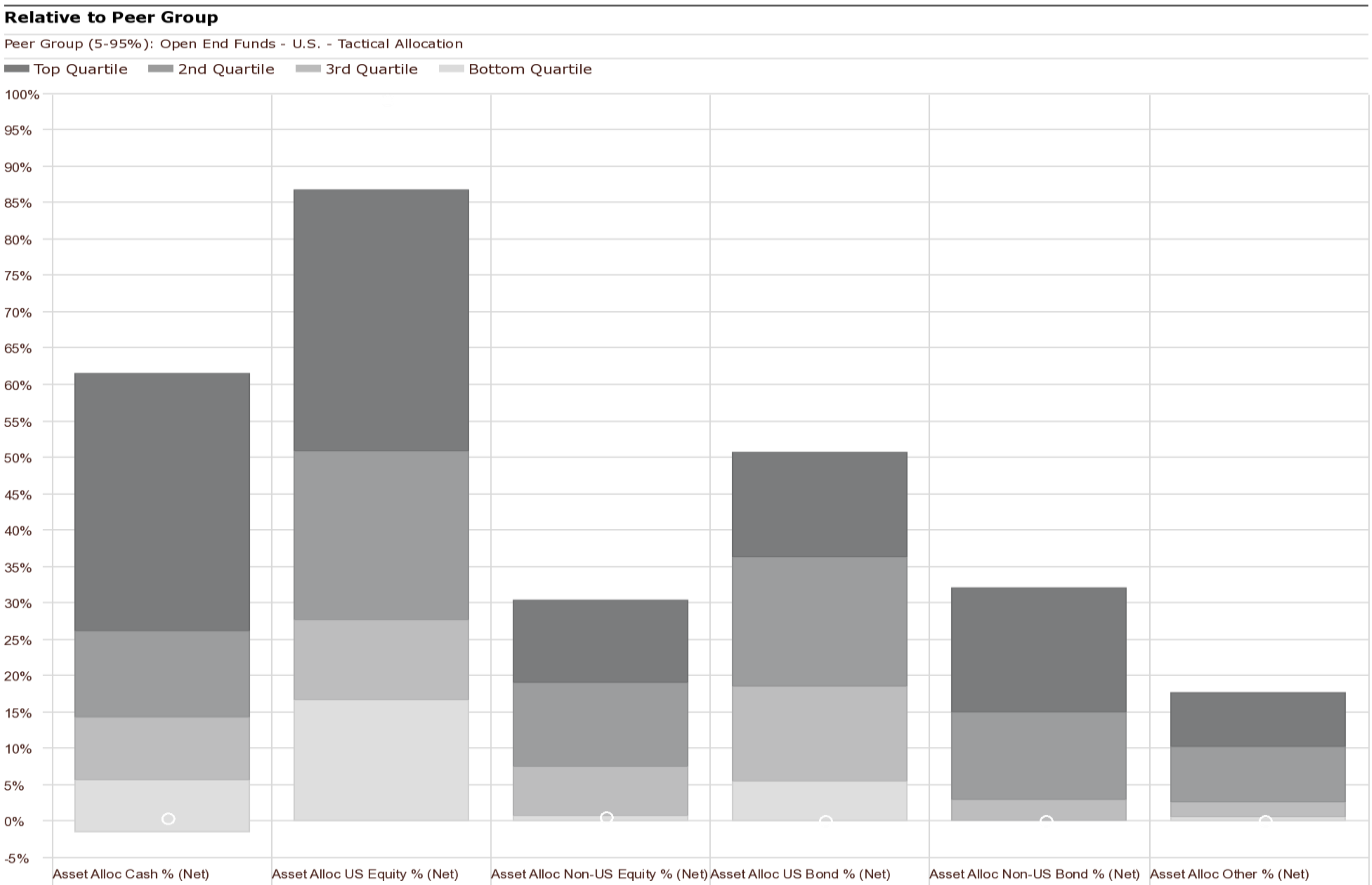
TAA strategies, on the other hand, have a high degree of uncertainty associated with them. In the graph below, we see a universe comparison on a year-by-year basis showing the range of returns from best to worst performers. The data set used here is Morningstar's Tactical Asset Allocation category. We can see that in any given year the range separating the best performers from the worst can be quite wide. The performance dispersions you see here are much larger than the plain vanilla asset classes.



Source: Morningstar Direct

Wide performance dispersions shouldn't be a surprise, given the fact that the asset allocations are all over the map.

In this last graph we see the range of asset allocations within the TAA category. TAA funds can take big bets, and they do. Across the category we see exposure to U.S. equity range from 0% to 85%. Cash ranges from 0% to more than 60%. U.S. bonds can be as low as nothing or as much as 50% of a portfolio.



Source: Morningstar Direct

Finally, TAA strategies tend to have higher turnover ratios and are thus less tax efficient. Their whole value proposition involves the active buying and selling of asset exposure in order to outperform the market. As turnover and tax efficiency are closely related, this is an additional concern for TAA strategies.

That said, it is really the value proposition of TAA strategies that Swan does not share. We believe it is too difficult to consistently time the market and that market-timing should not be the basis for a long-term strategy. When TAA bets go wrong, they can go very wrong.

That is why the Swan Defined Risk Strategy sticks to the motto:
“Always Invested, Always Hedged.”

Feel free to review more information on the Defined Risk Strategy performance, or its components, call 970.382.8901.

About the Author:

Marc Odo, CFA®, CAIA®, CIPM®, CFP®, Director of Investment Solutions, is responsible for helping clients and prospects gain a detailed understanding of Swan's Defined Risk Strategy, including how it fits into an overall investment strategy. Formerly Marc was the Director of Research for 11 years at Zephyr Associates.

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