ETFs – Tactical Asset Allocation Tools

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ETFs combine the advantages of both index funds and stocks. They are liquid, easy to use and can be traded in any quantity, just like stocks. At the same time an ETF provides the diversification, market tracking and low expense of an index fund. These characteristics combine to create an investment tool that provides investors with the broad exposure they require, at the level they want; at the moment they need it. As such they have been promoted and branded as an innovative investment opportunity. A claim greatly supported by the accelerated growth in ETFs, which clearly illustrates the appetite for such a product.

The major participants in the ETF market have historically been institutional investors. Some common institutional applications of ETFs include:

- Cash flow equitisation,
- Transition management,
- Core holdings – for smaller segregated accounts,
- Hedging key exposures,
- Asset allocation – global and tactical.

1. Tactical Asset Allocation

Institutional investors will make a strategic asset allocation, broadly between bonds and equities, based on long-term views of market opportunities and risks – this is sometimes called the "policy mix". The decision on how a fund's investments are allocated between stocks, bonds and cash has considerable impact on the performance and risk profile of the portfolio. In fact, the asset allocation decision has been shown to explain over 90 % of the return variability of a multi-asset fund as demonstrated below.

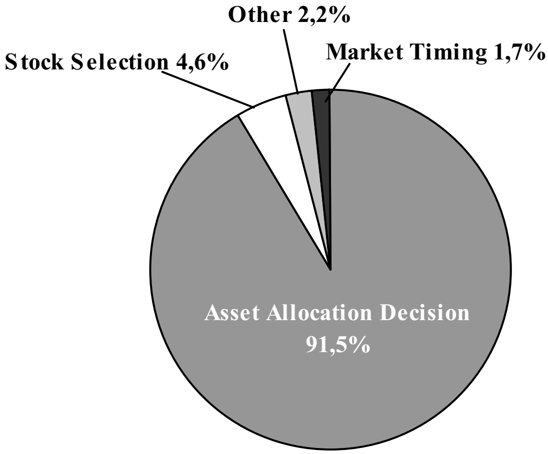

Figure 1: Asset Allocation. Source: Gary P. Brinson, Brian D. Singer and Gilbert L. Beebower, Financial Analysts Journal (May-June 1991)

Tactical asset allocation (TAA) is a quantitatively based investment strategy that maximises the "risk-adjusted return" by identifying and exploiting relative mispricings across asset classes. Although many strategies focus on finding the right mix between domestic stocks, bonds and cash, they can also extend to other asset classes such as real estate and international equities.

TAA complements the strategic asset allocation chosen by constantly reallocating around the portfolio's policy mix. The process assesses the expected return and risk of each asset class and rebalances the portfolio to optimally trade of total portfolio risk and total return. The source of the added return through TAA is attained exclusively through active shifts among the asset classes. The process is dynamic and will respond to changes in expectations and opportunities, adjusting the allocations within a portfolio to take advantage where these deviate from the expectations and opportunities of the strategic mix chosen.

A TAA strategy often implements the desired tilt towards each of the broad asset classes by gaining exposure to highly diversified index portfolios representing the asset class. This is typically achieved by direct investment in the underlying assets, through futures contracts or mutual funds and, over recent years, using ETFs.