



Economic Situation and Strategy

29 August 2024

Tactical allocation: the cherry on top of the cream cake

For years, a comparatively fierce dispute has been raging between supporters of passive and active investment approaches. Supporters of active approaches point out, not without justification, that passive and largely static portfolio structures by definition do not allow for tactical allocation, although it is precisely here that added value could be generated in the long term by varying the quotas of asset classes, countries or sectors. But how great is the potential of tactical allocation if the alternative would be to simply leave asset class weights static at benchmark levels?

We have tried to answer this question against the background of the almost legendary “Fundamental Law of Active Management”. This law was formulated by Richard Grinold and Ronald Kahn in 1995 and is now regarded as the gold standard when it comes to defining which factors play a role in achieving added value through active management compared to passive investment.

Without going into the specific formula in detail at this point, the law postulates that investment success ultimately depends on only two factors: Namely, on the quality of the decisions (measured by the hit rate) and on the number of independent decisions one makes. At first glance, this sounds plausible, and it is. Nevertheless, such a formula is ultimately comparatively abstract and leaves the practitioner with three questions. The first question is what hit rate must be aimed for in order to generate added value under realistic conditions. The second question concerns the necessary number of independent decisions. Do I have to make a new decision every day, or is it

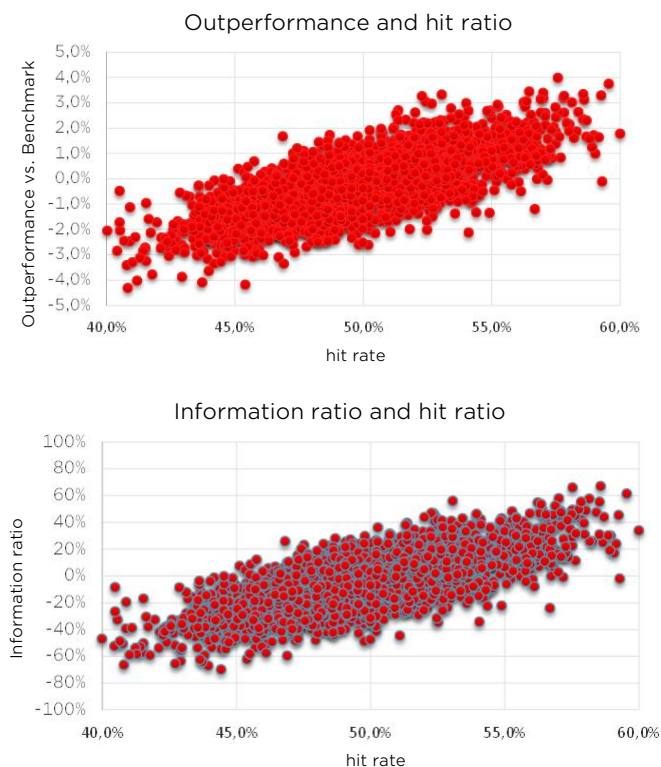
enough to make a tactical change every few months? And the third question derives from this: What exactly is the trade-off between the hit rate and the number of allocation decisions? Would it make more sense in practice to focus on one factor or the other?

Reality check on tactical allocation

We tried to answer these questions using concrete portfolios that could have existed in reality in exactly the same way. The first step of our experimental setup was as follows: For the years 1994 to 2024, the investor could invest in the DAX and German government bonds, each with a remaining term of five years. The passive reference investment consisted of a constant weighting of 50 percent for each asset class. In the comparison scenario with an active tactical allocation, a random generator decided for many thousands of portfolios when to deviate from this 50/50 weighting. In the event of a positive equity signal, the weighting was shifted to 85 percent DAX and 15 percent Bunds; in the event of a negative equity signal, the tactical allocation was mirrored. If the randomly selected tactical decision turned out to be correct, it was considered a “hit”. In this first run, the tactical allocation could be changed a maximum of once a month.

Our results

The result shows that, under these conditions, one would have to aim for a hit rate of 55 percent in order to achieve an annual out-performance of one percentage point with sufficient (but by no means absolute) certainty compared to the completely static investment without tactical allocation.



Of course, outperformance is not the only factor that interests an investor. In the end, you don't just want to generate an adequate outperformance on average; just as important is a continuous development of the outperformance and not an erratic development of the differential performance between strategic and tactical allocation. This is where the information ratio comes into play, which takes precisely these facts into account.

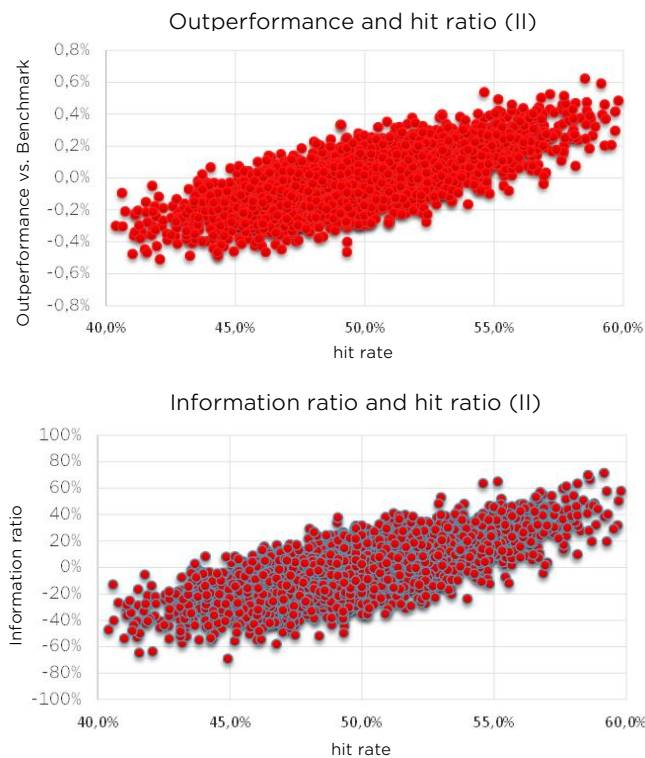
Outperformance vs. Information Ratio

A high information ratio indicates that you not only generate a good, but also a systematic and continuous outperformance. Our simulation shows that an information ratio of 0.5, which is often aimed for, can hardly be achieved with a hit rate of 55 percent. An information ratio of 0.25 with a hit rate of 55 percent is more realistic.

But does the result change if the tactical decisions are implemented less aggressively? We tested this alternative scenario by increasing the equity allocation by only 5 percentage points instead of 35 percentage points in the case of positive tactical signals for equities. This shows that, for a given hit rate, the possible outperformance shrinks significantly, but the information ratio is not affected - exactly as the fundamental law of active management would predict on the basis of the formula.

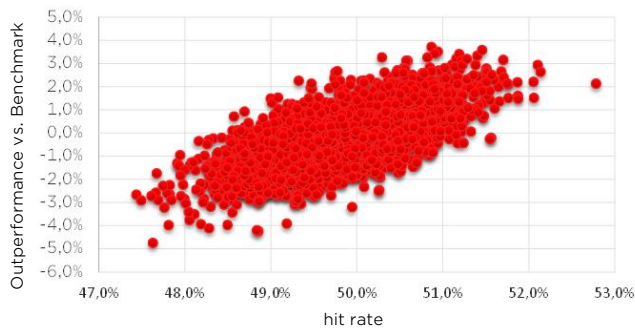
So is there no disadvantage at all if you only rely on homeopathic tactical allocation decisions? Unfortunately,

it's not quite that simple. This is because the previous calculation was based on the assumption that there are no costs - but this is an unrealistic assumption. A tactical allocation cannot be offered completely free of charge; in terms of costs, the expected outperformance with a hit rate of 55 percent would be very modest. The same applies to the expected information ratio.

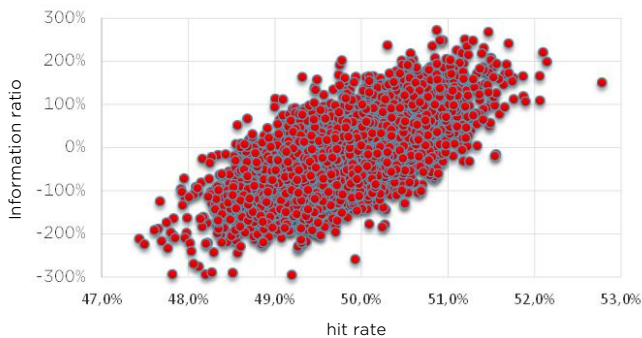


What would change if the frequency and thus the number of possible independent decisions were to be significantly increased? We have run through this scenario in which a tactical decision could, but did not have to, be made every day for the last 30 years. It is noticeable here that with an aggressive implementation of the tactical allocation (35 percentage points change from the strategic 50/50 allocation with allocation signal), both an attractive outperformance and an attractive information ratio can be achieved with significantly reduced hit rates. This is not a miscalculation - moreover, this is precisely the relationship postulated by the fundamental law of active management. For practitioners, however, the question now arises as to whether this may even be the key to success. Wouldn't it be much easier to make a decision of lower quality more often than a decision of higher quality less often?

Outperformance and hit ratio (III)



Information ratio and hit ratio (II)



We cannot answer this question definitively, but would like to point out that decisions with a short “half-life” of one day are subject to extreme market noise, so that even from this perspective, higher hit rates of 52 percent or 53 percent based on daily decisions seem impossible. If, on the other hand, tactical decisions are only made a few times a year, the hit rates must be substantially higher; however, since the “noise” of the markets is less relevant with a view to one or several months and fundamental facts play a more important role and come to the fore, higher hit rates should also be possible. However, experience shows that successful hedge funds, which have proven to be successful over many years and decades, have tended to rely on a combination of many independent decisions and rather low hit rates. However, this presupposes that you have to have a new opinion on every

asset class almost every day. Those who work purely quantitatively may be able to do this - but those who manage their portfolios more classically and qualitatively cannot possibly have a new opinion every day, because the fundamental picture does not change that quickly.

What can be deduced from these calculations? First of all, it shows that the instrument of tactical allocation certainly offers the potential to deliver added value compared to a static strategic allocation. However, if you do not implement your allocation opinion with very aggressive deviations from the benchmark allocation, the expected outperformance after costs is rather modest, even with a high hit rate of 55 percent.

Strategic allocation is also important!

This shows that, in addition to good tactics, another point is very decisive for performance: the composition of the strategic allocation. This is because it is crucial for performance how high the strategic equity allocation is, and it can be just as decisive whether you are invested in the USA or in Europe, whether you opt for a short or long duration for bonds and whether high-yield bonds are part of the strategic allocation or not. Depending on these strategic decisions, very different return paths can then develop.

A good tactic is ultimately the cherry on the cake, but a bad cake cannot be saved even with a pretty cherry. It therefore makes sense to pay attention to good tactics - but if you neglect the strategy, you are also making a big mistake and perhaps even the biggest one.

Dr. Christian Jasperneite

Market data

	As of 29.08.2024 15:21	Change versus				
		22.08.2024 -1 week	26.07.2024 -1 month	28.05.2024 -3 months	28.08.2023 -1 year	29.12.2023 YTD
Stock markets						
Dow Jones	41091	0,9%	1,2%	5,8%	18,9%	9,0%
S&P 500	5627	1,0%	3,1%	6,0%	26,9%	18,0%
Nasdaq	17556	-0,4%	1,1%	3,2%	28,1%	17,0%
DAX	18902	2,2%	2,6%	1,2%	19,7%	12,8%
MDAX	25472	2,0%	1,4%	-6,1%	-6,7%	-6,1%
TecDAX	3402	2,0%	2,1%	-0,2%	9,1%	1,9%
EuroStoxx 50	4958	1,5%	2,0%	-1,4%	15,5%	9,7%
Stoxx 50	4546	1,4%	2,2%	1,5%	14,9%	11,0%
SMI (Swiss Market Index)	12409	0,8%	1,4%	4,7%	12,5%	11,4%
Nikkei 225	38363	0,4%	1,8%	-1,3%	19,2%	14,6%
Brasilien BOVESPA	137174	1,5%	7,6%	10,8%	17,1%	2,2%
Indien BSE 30	82135	1,3%	1,0%	9,3%	26,4%	13,7%
China CSI 300	3278	-1,1%	-3,9%	-9,2%	-12,7%	-4,5%
MSCI Welt	3631	0,7%	3,0%	4,8%	23,7%	14,6%
MSCI Emerging Markets	1097	-0,3%	2,3%	0,8%	12,2%	7,2%
Bond markets						
Bund-Future	134,09	-16	137	407	218	-313
Bobl-Future	117,73	-4	70	147	227	-155
Schatz-Future	106,27	5	34	126	133	-28
3 Monats Euribor	3,51	-16	-16	-40	-27	-38
3M Euribor Future, Dec 2024	3,00	0	-17	-36	-31	70
3 Monats \$ Libor	5,32	-1	-20	-29	-35	-27
Fed Funds Future, Dec 2024	4,53	-3	-26	-57	1	69
10 year US Treasuries	3,87	1	-32	-67	-34	1
10 year Bunds	2,27	9	-7	-30	-27	27
10 year JGB	0,89	1	-14	-13	24	27
10 year Swiss Government	0,43	0	-7	-40	-54	-27
US Treas 10Y Performance	618,06	0,2%	3,1%	6,8%	7,0%	2,8%
Bund 10Y Performance	565,39	0,0%	1,3%	3,6%	5,3%	0,0%
REX Performance Index	451,72	0,1%	1,4%	2,7%	4,5%	0,9%
IBOXX AA, €	3,17	1	-10	-32	-60	10
IBOXX BBB, €	3,67	1	-11	-37	-94	-8
ML US High Yield	7,48	-8	-30	-64	-114	-32
Commodities						
MG Base Metal Index	418,23	0,6%	4,4%	-10,3%	8,9%	7,0%
Crude oil Brent	79,18	2,4%	-1,6%	-5,7%	-6,3%	1,9%
Gold	2513,61	1,4%	5,5%	6,7%	31,0%	21,7%
Silver	29,36	0,9%	5,5%	-8,4%	20,6%	21,1%
Aluminium	2466,93	0,2%	10,4%	-8,1%	16,7%	5,2%
Copper	9129,97	1,3%	1,5%	-12,0%	9,7%	7,9%
Iron ore	98,51	0,3%	-7,8%	-16,3%	-9,0%	-27,8%
Freight rates Baltic Dry Index	1755	-0,7%	-2,9%	-1,6%	62,5%	-16,2%
Currencies						
EUR/ USD	1,1086	-0,4%	2,1%	1,9%	2,6%	0,3%
EUR/ GBP	0,8419	-0,8%	-0,3%	-1,1%	-2,0%	-2,8%
EUR/ JPY	161,09	-1,0%	-4,0%	-5,5%	1,7%	3,0%
EUR/ CHF	0,9383	-1,1%	-2,2%	-5,3%	-1,8%	1,3%
USD/ CNY	7,0992	-0,7%	-2,2%	-2,0%	-2,7%	-0,1%
USD/ JPY	144,58	-1,2%	-5,9%	-8,0%	-1,3%	2,5%
USD/ GBP	0,76	-0,5%	-2,4%	-2,9%	-4,5%	-3,2%

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