Analysis

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More active tactical asset allocation paying off

Key take-aways

- Global trends are making market volatility more extreme and more frequent, including diverging national policies, increasing trading automation, more quantitative and high-frequency trading, and increasingly unpredictable government moves, among others.
- These conditions give M&G Investments more opportunities to exploit mis-priced assets and add alpha to client portfolios, leading us to become even more active in our tactical asset allocation approach.

For those who may not know, tactical asset allocation (TAA) is a process in which an investment manager aims to generate additional alpha in a portfolio by taking advantage of shorter-term mis-pricing in an asset class or classes. They buy more of an asset class for a portfolio when they deem its valuation to be cheap, or sell some of their holdings when it becomes expensive – and this can be on either an absolute basis (if it is assessed to be trading below or above its long-term fair value) or relative to other asset classes. They then readjust this allocation back to nearer its longer-term (strategic) level once the asset valuation moves back closer to its fair value. In this way they add shorter-term returns to the overall portfolio, rather than simply buying and holding assets in fixed weights over time.

At M&G Investments we have employed this approach to add value to client returns for several decades now, and were one of its pioneers in Southern Africa, particularly in our institutional client portfolios. What is different now is that in the past few years, particularly during the Covid market crash and ensuing recovery, we have found that TAA has become an increasingly important tool in our investment toolkit.

Why is this? From a macro perspective, we have found more frequent opportunities to use TAA, and been employing it over shorter periods of time. Our increasingly active approach has been due to the rise in the number of episodes of market volatility globally, and the higher degree and shorter timeframes of asset price movements themselves. This is a trend that has been developing globally, in which equity and bond market moves have become less correlated among countries, resulting partly from a rise in idiosyncratic behaviours by individual nations.

National policies diverge

We have seen a move away from the broad global adoption of neo-liberal policies of the 1990s-2000s toward spreading neo-nationalistic policies reflected in the politics of Donald Trump, strong anti-immigration, anti-trade views, etc., and this in turn has resulted in more unpredictable, idiosyncratic and less correlated market movements. Individual country risks are becoming notably more material in our analysis.

Examples of this are numerous, especially in foreign exchange markets, and include: the sudden depreciation and general volatility of the Mexican peso triggered by Trump's rhetoric around the border wall and the North American Free Trade Agreement; the UK pound around Brexit; short-lived crashes in emerging market bonds; China's latest regulation efforts which caused plunges in the share prices of Chinese tech stocks; etc. Investors like ourselves have been able to take advantage of these short-term aberrations in valuations to buy into a security at a cheap valuation, either to hold onto it to take advantage of its capital growth prospects, or to sell it in the shorter-term for a "quick" addition to portfolio alpha.

Changing market structures and technologies

Equally, the structural features of today's financial markets are creating more inefficiencies that we are able to exploit in our TAA approach, making us increasingly interventionist. The higher prevalence of automated and high-frequency trading, quantitative strategies and risk management practices, among others, can create "flash crashes", extreme momentum and other mispricing opportunities. These events can lead us to buy or sell more quickly than before, as well as re-assessing our new positions more frequently,

The upside to volatility and divergence

On the surface it may appear that the higher frequency and degree of market volatility is purely negative for investors, creating more "bad news" headlines, uncertainty and confusion, as well as less predictability. However, for valuation-based investors like M&G Investments, the trend has upside in that it gives us more chances to create value for our clients, while also improving the benefits of diversification in a world where many markets can be driven by the same factors and the same sentiment. These days there is a wider spread between emerging market bond yields as increasingly different sovereign risks are being priced into them, for example, and we can bring our investment expertise to bear on determining which are the most attractively valued given the risks involved.

So amid the current trends of diverging national political and economic models, more complexity and unpredictability, and higher market volatility, a more active asset allocation approach is proving increasingly beneficial for adding alpha to client portfolios. Hand in hand with this comes the need for more careful investment analysis, to ensure we avoid value traps and identify the correct levels at which to buy and sell securities. In such an environment, a global valuation-based investment manager with a successful long-term track record in active TAA, plus a wealth of management expertise and deep resources, is best-positioned to help clients achieve their investment goals. □

Eric joined M&G Investments in 2006 and is a member of the M&G Macro & Multi Asset Business based in London. He previously worked a Managing Director and Head of Macro Research at JP Morgan Cazenove. His qualifications include a BA in Philosophy, Politics and Economics from Pembroke College, Oxford, and an MSc in economics from the London School of Economics.