In Practice: Tactical Funds Miss Their Chance

"Tactical allocation" funds have been attracting assets, but our updated study finds that performance leaves much to be desired.
Jeffrey Ptak, 02/02/2012

It was a little over a year ago that we examined the success of "tactical allocation" mutual funds ("Tactical Strategies Miss Their Mark," October/November 2010 issue). Tactical funds, which have been around for years but enjoyed a burst of popularity after the financial crisis, typically eschew investing in a static mix of investments like a traditional balanced fund would. Instead, they rapidly shift between asset classes, often in following macroeconomic or trend-following strategies.

Proponents argue that tactical allocation can be valuable in bear markets or amid heavy volatility given their flexibility, which helps them to sidestep trouble. However, our earlier research found that these funds generally failed to deliver better risk-adjusted returns, or downside protection, than a traditional balanced index portfolio split 60%/40% between stocks and bonds, respectively.

That said, our study only ran through July 2010. Since then, markets have been choppy and range-bound at times, a climate that one could argue is better suited to tactical funds. (Many such funds fared poorly in the wake of the crisis, when markets rebounded sharply.) In addition, a number of the funds that we examined had launched recently, leaving them with relatively short track records at the time we conducted our earlier study. More prosaically, these funds have continued to attract assets at an impressive clip: Based on Morningstar estimates, the 155 active tactical funds that we track gathered more than $10 billion in net new monies for the year to date through Nov. 30, 2011.

For those reasons, we decided to update our research to incorporate more-recent performance and assess how well these funds have done of late.

Our Peer Group

In our earlier study, we examined 163 tactical funds, including 39 that had previously been liquidated or merged out of existence. As of Dec. 31, 2011, that tally had risen to 210 funds, as fund companies launched a bevy of tactical strategies in the latter half of 2010 and throughout 2011.

Our Study

To extend our previous findings, we measured each tactical fund's net annualized return, standard deviation, Sharpe ratio, and maximum drawdown from July 31, 2010, to Dec. 31, 2011. We then compared our findings with the results of Vanguard Balanced Index VBINX, which passively invests its assets in a 60%/40% stock/bond mix. (This extends the results of virtually every fund in our previous study, with the exception of 15 tactical funds that were merged or liquidated away since July 2010.)

Our Findings

We found that very few tactical funds generated better risk-adjusted returns than Vanguard Balanced Index's over the extended time period we studied.

Just nine of the 112 tactical funds that existed for the full 17-month period earned a higher Sharpe ratio than the Vanguard fund.

Only 27 of the funds had a smaller “maximum drawdown” than Vanguard Balanced Index, meaning that the clear majority suffered larger peak-to-trough declines (Exhibit 1).

In short, our extended study found scant evidence that these funds delivered on their goal of delivering competitive returns with a smoother ride. Most gained less than the Vanguard fund, were more volatile and prone to downside, or both. This is consistent with our previous findings.

To be fair, one could argue that the extended time period we studied really spanned three distinct markets—a continuing equity bull market (Aug. 1, 2010, to April 30, 2011), a sharp correction (May 1, 2011, to Aug. 21, 2011), and a renewed rally (Aug. 22, 2011, to Dec. 31, 2011). So, the question is whether these funds better distinguished themselves amid the spring and summer tumult, when downside avoidance was more important than upside capture.

The short answer is yes, though to a disappointing extent. We measured the maximum drawdown of each tactical fund during the May 1–Aug. 21, 2011, period and then sorted by decile, with funds that suffered the largest drawdowns in the 10th decile and those with the smallest in the 1st decile (Exhibit 2). We found that around 40 of the 112 tactical funds experienced smaller drawdowns than Vanguard Balanced (negative 9.46%). However, that means more than half of the tactical funds fell more than the Vanguard fund; what’s more, the negative 11.08% median drawdown was about 10 percentage points larger than one would have suffered hunkered down in investment-grade U.S. bonds during the period.

This last finding should give pause to those who are considering tactical funds as a form of “tail insurance” against extreme negative events. While some of these funds have proved more resilient when the stock market is falling, we found it’s far from a sure thing. Indeed, only 14 of the 81 tactical mutual funds in existence since October 2007 posted lower downside-capture ratios during the 2008 financial crisis, and the spring/ summer 2010 correction, as well as the recent European debt-related downturn. In other words, there was a less than one-in-five chance that the insurance would consistently pay off versus what one could achieve through a simple balanced fund (Exhibit 3).

Of course, one could argue that the only truly extreme episode was the financial crisis itself and, on that score, tactical funds acquitted themselves far better—44 of the 81 tactical funds existing at the start of the crisis came through it capturing less downside than the Vanguard fund. But that protection came at a steep cost, as only six of the 44 funds captured at least as much upside as Vanguard Balanced Index in the subsequent months, with the typical fund in that cohort capturing a meager 46% of the upside versus 62% for the Vanguard fund. (This likely overstates the upside capture of this group, as 12 of the 44 funds were merged or liquidated post crisis, presumably because they missed out on a huge portion of the gains. Those funds lacked results for the full post-crisis period, so they were excluded from the data used to calculate the 46% upside-capture ratio.)

Performance issues notwithstanding, the last question we examined was whether, in general, an allocation to tactical funds could have other, salutary diversifying properties. That is, could they help, perhaps because of their professed focus on downside, to make portfolios more efficient? (In our previous study, we didn’t examine this question largely because so many of the funds hadn’t existed for a full market cycle, making the peer group’s diversification potential difficult to assess.)

To evaluate that question, we calculated the monthly average returns of all funds in our peer group, including merged and liquidated funds, for the 10-year period ended Dec. 31, 2011. We then combined that tactical-fund average return stream ("tactical average") with the monthly returns of the Vanguard fund under several hypothetical portfolio scenarios:

90% Vanguard fund/10% Tactical average
80% Vanguard fund/20% Tactical average
60% Vanguard fund/40% Tactical average

From there, we calculated the rolling threeyear Sharpe ratios of these hypothetical portfolios and compared them with a portfolio that invested exclusively in the Vanguard fund, tallying up the differences (the hypothetical portfolio's Sharpe ratio minus the Vanguard fund's Sharpe ratio, for each rolling period).

What we found was that an allocation to the average tactical fund-be it 10%, 20%, or 40%-conferred better risk-adjusted returns (as evidenced by a higher Sharpe ratio) in fewer than one third of the 97 rolling three-year periods (Exhibit 4). This is striking, given that the 10-year period in question saw fairly tepid U.S. large-cap equity returns, a trend that ostensibly should have made the Vanguard fund-which skews heavily to such stocks in its equity sleeve-easier to complement.

Conclusion

In extending our study of tactical mutual funds through Dec. 31, 2011, we found that tactical funds generally struggled to deliver competitive risk-adjusted returns when compared with a traditional balanced fund. With a few exceptions, they gained less, were more volatile, or were subject to just as much downside risk as a 60%/40% mix of U.S. stocks and bonds. These findings largely reaffirm our earlier study of tactical funds. In addition, we also found, in a simulation of various hypothetical portfolios over the 10-year period ended Dec. 31, 2011, that the average tactical fund would have delivered little incremental diversification.

To be sure, several tactical funds, such as PIMCO All-Asset PASAX and GMO Global Asset Allocation GMWAX, have continued to enjoy notable success. But most of the funds that we evaluated were inconsistent performers at best. Thus, it stands to reason that investors seeking to add ballast to a portfolio should be very selective in considering tactical funds. Our research suggests that, in all but a few instances, they would be better served simply hiking their portfolio's bond stake or utilizing alternatives like precious metals.