INVESTMENT BULLETIN

Keel Point

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Keel Point's Internal Tactical Strategy

As stock markets ratchet from all-time-high to all-time-high we increasingly hear from clients interested in how we can navigate such an environment. We all know there is a sell-off somewhere on the horizon – what do we intend to do about it? The question scores at a higher than normal level of difficulty since there are few alternatives to stocks that aren't bouncing around all-time highs. Our answer to the challenge is twofold – the first is more of a clarification, the second more opportunistic.

The first part of the answer is that we intentionally divide portfolios into *strategic* and *tactical* sections. Every client begins with a strategic portfolio and those that desire pair a tactical portfolio alongside it. Strategic portfolios are built to consistently experience risk in the proximity of a benchmark. For instance, a growth portfolio should lose about as much as a portfolio of 75% global stocks and 25% US bonds in a bear market. The idea is that clients in a growth portfolio accept the downside of a 75/25 portfolio based on an understanding of its historical risk characteristics. We intend to occasionally take more or less risk than the benchmark if we see opportunities to do so, but these deviations will usually be small. For example, we never expect to reduce the risk of a growth portfolio (75/25) down to the intermediate level (which would expect downside risk commensurate with a 55%/45% blend).

Tactical portfolios have a different objective, one more aligned with the question above: to intentionally increase or decrease risk as we estimate changes in the market environment. The market-at-all-time-highs narrative alone would not lead to risk reduction, but poor equity trading strength and deteriorating economic data, if present, might. The rest of the discussion here will explain the design of Keel Point's internal tactical program – how we incorporate trading strength and economic data into our process – beginning with the bottom-up security selection methodology.

Sector Strength

The tactical strategy selects investments from a universe of 60 ETFs representing different slices of capital markets:

- 21 US equity ETFs, including styles (e.g. growth), size (e.g. small cap), and sectors (e.g. consumer staples)
- 21 non-US equity ETFs, including regions (e.g. Asia Pacific) and countries (e.g. Germany)
- 9 fixed income ETFs (e.g. high yield)
- 9 alternative ETFs (e.g. global timber)

We construct the tactical portfolio with the sectors that are at the top of our weekly in-house trading strength ranking, calculated in four variations over three time periods. Generally, eight to twelve sectors are chosen and size is capped at around 8% of the portfolio. Investment decisions rest mostly on this ranking process, but the team does reserve a qualitative oversight role. In other words, human discretion sometimes overrules the ranking: we might decide not to buy a top-ranked sector or not to sell a sector losing steam if we believe information outside of the ranking process, such as geopolitical concerns, supports the decision.

What is so special about trading strength? Most importantly, our internal data shows that strong recent performance (i.e. trading strength) is predicative of future strong performance. Beyond this, we draw confidence from certain intuitions. Behavioral economists observe that new information about securities tends to impact market pricing gradually rather than immediately. Market participants are anchored to prior beliefs and slow to change their minds in the face of new information. Further, people struggle to fight the urge to chase recent high returns. Taken together, we believe it is reasonable to expect recent trading strength to predict future trading strength on average.

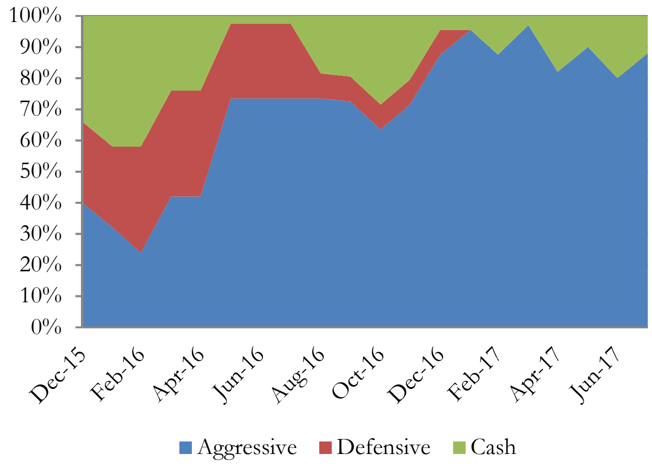
How Does Risk Move Up and Down?

The process of sector selection naturally results in a portfolio that moves between aggressive and more conservative risk postures. Bull markets lead to trading strength in equity and equity-like ("aggressive") sectors, while bear markets lead to strength in certain bond and alternative ("defensive") sectors. The tactical portfolio picks up aggressive investments as bull markets manifest and trades them in for defensive investments as the bull corrects.

Figure 1 on the next page shows how this process has worked over the 19 months we have offered the tactical strategy in this format. This is certainly a short period, but it happens to be rich with events that illustrate how the strategy works.

First, focus on the blue shaded region that shows the share of the tactical portfolio invested in aggressive sectors. Most equity sectors traded weakly in the final third of 2015. China's surprise devaluation in August and global growth fears weighed on returns. Tactical thus opened the 2016 New Year cautiously with just shy of 40% invested in aggressive positions. This worked in our favor as equity markets continued to sputter through the middle of February. As they rebounded in the spring, the portfolio added aggressive exposure until it was nearly 75% aggressive by June. The next major shift in positioning occurred as the strategy picked up on the Trump bump. Post-election, the portfolio has stayed in the 80 to 90% aggressive neighborhood.

Figure 1: Historical Tactical Positioning
Source: Keel Point Tactical Program



We pause here to note when a portfolio constructed this way might be expected to shine or suffer. Tactical shares some characteristics with trend-following, or managed futures, strategies. Neither is constructed to "call" a turn in the market. Rather, they are designed to move quickly from aggressive to defensive (or vice versa) once the turn comes. Thus, they tend to work well in markets that move in one direction for a meaningful amount of time, as they will be correctly positioned, aggressively or defensively, for a sustained period. On the other hand, when markets turn frequently, tactical strategies such as ours are correctly positioned for too short of a period to get traction.

We also note that the sector selection methodology, while adding value over time based on our analysis, introduces a separate source of variability to returns. The tactical model clearly performs best when both the aggressive/defensive posture and sector selection within those categories is correct. We will be wrong on one or both counts from time to time. Returns will suffer, for instance, in periods when we are correctly positioned aggressively, but a rapid rotation in aggressive sector leadership from US to non-US equity causes the tactical model to lag in short-term performance.

The Indicator Overlay

There is another key determinant of risk-taking in the portfolio. We look at an ensemble of broad economic and high-level (i.e. above the sector level data that drives investment selection) market data to form a top-down view of the appropriate level of risk to take. This process often ends with a pull on the cash lever available to the tactical portfolio. Returning to Figure 1 you can see the green cash region has moved around quite a bit – from 40% at the beginning of 2016 to 10% or 20% more recently. This can be a function of a poor opportunity set – maybe only six sectors exhibit trading strength leaving us with less than a full portfolio. However, cash positioning is also informed by trepidation coming though the high-level indicator data. For example, reacting to soft economic reports, we increased cash in May 2017 as a preliminary step towards defensiveness. As data and sentiment firmed up our outlook improved and cash was put to work.

In the Portfolio Context

Assuming a portfolio's strategic risk level is correct, an allocation to tactical's dynamic risk-taking strategy is one of our answers to the all-time-highs question. Market tops are historically difficult to call. It is possible to be wrong for a very long time; in the US, we've been in a market environment at or near highs for much of the past five years. We believe the data-driven engine of the tactical strategy, and the intuition behind it, leads to repositioning that is correct frequently enough to make a positive contribution to portfolios.

We know this investing approach resonates with some and not others. It is certainly reasonable to select an appropriate strategic portfolio and elect no tactical management. Those focused on tax efficiency may prefer this, as tactical will generate short-term holding periods. For those with the opposite view, however, we don't recommend investing all or a majority of a portfolio with a tactical mandate. We believe strategic and tactical are most effective as complements with the strategic side capturing at least 70% of the total portfolio. We encourage those interested in the strategy to inquire with us for more up-to-date information about the positioning and performance of our tactical strategy. □