EP109 - Chasing Trends, Losing Wealth: The Tactical Allocation Trap

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Keith Matthews: Welcome to the Empowered Investor. My name is Keith Matthews and I'm joined by my cohost, Marcelo Taboada. Marcelo, how are you today?

Marcelo Taboada: Keith, I'm good. I'm excited about the subject today. It's something that comes up often every time there's turbulence in the market. we have this amazing report from Morningstar showing some interesting data points that we're going to discuss today, and it's a good subject.

Keith Matthews: The report we got was last week was on how well tactical asset allocation funds have done. It was calendar 2024, but they reviewed five year returns, actually one year returns, five year returns, 10 year and 20 year returns and there's some important implications and lessons we can learn in terms of how active one should be when an individual Considers trading a portfolio moving from one asset class to another in today's show We're going to really discuss Do tactical asset allocation funds add value?

The inference here is, is it valuable? Does it make sense for individuals to move pieces of their portfolio around? there's much to talk about whether you're an individual investor doing this, whether you're an advisor doing this, whether you believe in the process. this report sheds a lot of light that we can expand on across all these areas. We're going to talk about how they actually did. We've got live data, just very recent, how they did. We're going to talk about whether they reduce risk in a portfolio. We're going to talk about actually the reasons why they didn't do as well as we would have all thought. And it has to do with allocations, when they actually moved.

Asset allocations and did it work out? And then the really big thing is the takeaways, the lessons, because, you know, we're going through a period, even right now, Marcelo, as you know, with the tariffs, everybody's saying, what should I do with my portfolio? Should I change something? And the reality is, there's always history shows that there's always something to worry about.

Marcelo Taboada: There's always something to worry about. And it's hard to predict. We're going to talk about that. But the good thing about the report, Keith, is that we had one going back until 2022. this has been updated. I was curious to see the numbers because as you know, 2023, 2024 were remarkable years in the stock market.

I was curious to see how the tactical allocation funds had done. And to our, not surprise, but to our advantage, I'd say we saw similar numbers as the previous studies. We just confirmed that. The studies that have been done on the subject are robust and they're coming across different time periods and they're maintaining their results.

Keith Matthews: Yeah, absolutely. let's jump in and let's just discuss first and foremost, what is a tactical asset allocation fund?

Marcelo Taboada: Yeah. look, the simplest definition is you are buying a product that promises Our performance obviously offers protection during the downturn and is allowed to shift the asset allocation. How much allocation you have to bonds and stocks or cash in different market environments. that could be macroeconomic events, global politics events, local events, you name it. if you have a global portfolio that allocates money tactically, they can shift things around. As their view changes of the market, to speak.

Keith Matthews: I the way Morningstar phrased it. They called it the quintessential managed strategy. Yes. a lot of large firms, banks, money management organizations would create these strategies, charge an extra fee versus a more traditional buy and hold asset allocation, because in theory, you're buying something extra, you're buying this extra movement.

And these firms, they're mandated to put together a team, the team could have five professionals, it could have 50 professionals, individuals who study the market, study the trends, They study predictions. They study everything they can possibly come up with. They do this full time. They do this full time.

And then they move assets around. they might reduce equity weightings and go to bonds, or they might reduce certain geographic weightings. less Canada, more U.S., vice versa, more international, and they're allowed to have a free carte de blanche to manage money. Sounds very enticing. That's why Morningstar has phrased them the quintessential manager.

How do they differ from what we would do, for example, which is set a portfolio asset allocation strategic and hold it for the long term or other advisory firms as well?

Marcelo Taboada: Yeah. the traditional models, we said, is you have a set split of stocks and bonds. call it 60% Stocks, 40% bonds, and it could be anything.

It could be an 80/20, it could be 100% stock, whatever the allocation is. It could be 100% equity broken down with a third in the U.S., a third in Canada, and a third in international markets. You name it. And then you would rebalance periodically, you would set up a rules based approach where you say either half a year or quarterly or once a year, I'm going to go in, rebalance the portfolio. If you have a lot of equities, you will sell some of those and buy some bonds to keep your static allocation in the same way that you've set it up previously. that's the big difference between the two.

Keith Matthews: Yeah. And then specifically, how we would actually manage money is if clients are adding money to their portfolio. Or investors, what we would propose most investors do. If you're adding money into your portfolio, buy the asset class that have underperformed a little bit, shore them up, add to them that their level gets back to the long term strategic asset allocation. And if you need money out of your portfolio, if you're withdrawing capital, you take from the asset classes that have done extremely well.

And that's another way of almost giving the portfolio a haircut. If you will, making sure that you're always looking proper and in line with the long term asset allocation. So, we've been managing and we've been big proponents of set these allocations and rebalance. Do some fine tuning, but don't do the major shifts.

Marcelo Taboada: Yeah, and I said, the rebalancing is rules based. So, it's not we're going to wake up one day and say, Hey, we're rebalancing today because the market's doing X. We do it. With a set schedule, we're respecting rules when it comes to the rebalance.

Keith Matthews: Okay, now we've set the framework here in terms of what the two different options are. One is tactical, move money around, and the other one is more set and rebalance. let's now go into the results. Morningstar released their research on February 4th, less than a week ago, and it was their 2025 asset review. Had to do with the last five years, but in particular 2024, actually I say last five years all the way back for 20 years.

What do the returns look Marcelo?

Marcelo Taboada: I would say they are consistent. if we look at 2020, for example, the return on a 60, 40 basic portfolio that doesn't move, you know, that's what we call a strategic asset allocation or a set allocation that return about 16%, the tactical allocation return about 10%.

That's a big gap. And then it remains consistent. 2021, you see similar numbers. the 60/40 portfolio beat the tactical allocation again. And then 2022, we do have to give credit where it's due. the tactical funds lost a little bit less than the strategic allocation ones, the set 60/40. there are years where it's not going to work, right?

Marcelo Taboada: You look at 2023 and 2024, which were two years where The market did really well, and again, the 60/40 fund ended up beating the tactical allocation fund by some gap, I would say. 2023, there's an outperformance of about 18 to 10%, about 8%. And then in 2024, the 60/40 portfolio return 15%, and the tactical allocation return 10% on average. That's about an out performance of 5%.

Keith Matthews: Yeah, and I think what's very telling about this period, in this particular view, we're looking at 2020, the year of the pandemic, 2021 pandemic, 2022 was a down market, was a difficult down market, '23 and '24. you've got pandemic, you've got Ukraine Russia war.

You've got increasing interest rates, inflation, you've got potential recession, you've got decreasing interest rates. you have a lot of different moving parts that you couldn't predict on.

Marcelo Taboada: Yeah, and even 2024 you had rumblings of Donald Trump again and his talk about tariffs and different things. there's always stuff here.

Keith Matthews: Yeah, but where I'm going with this is that I'm saying, okay, if they had a chance to prove that they were worth it, they got the reps, they got the reps. they got opportunities. Yeah, of course. And this is almost the same as all these other periods as well that we go through, where there's no excuses here.

They're given all these moving parts. If it makes sense, they should be able to perform and they're not getting the numbers.

Marcelo Taboada: And for the listener, think about that for a second. You are. Consistently underperforming a portfolio of boring asset allocation of 60/40. That's not moving. It's staying constant rebalance.

What, by the way, in the study, they do allude to the fact that the 6040 that they're looking at, it is rebalanced once a year. they are selling what did well and buying what didn't do well to keep at the 60/40, whereas the other one is shifting things around all over the place. And that did worse.

Keith Matthews: Yeah and again, I think they refer to a 60/40, but they also a benchmark to moderate. Regardless of what you're benchmarking, whether you're doing an asset allocation based on a growth mandate or a high equity mandate, this same outcome is coming through, which is the more you think you can maneuver, the more you think you can win by these major bold adjustments.

In a second, we'll share with the listeners what these adjustments look like. The more you do this, unfortunately, you just don't see the results coming through. And I look at this and say, well, geez, if Goldman Sachs or Morgan Stanley or RBC, or any of these organizations that have these strategies that are called tactics, if they can't do it, what makes an individual investor think that they can do it?

What makes an investor think that their advisor can do it? What makes an investor think that the advisory firm that some firms might have five, 10, 15, 20, what makes anybody think that they can do it? And you know that a lot of investment centric firms are doing this stuff. Of course. Oh, we see it because we've talked with potential clients who are coming on board.

Marcelo Taboada: They talk about their experiences and how they either got it right or wrong. Some bold moves and why they think it makes sense. And it's hard for people to acknowledge, but sometimes setting a long term strategy and just doing rebalancing along the way and working on financial planning and tax efficiency is perhaps sometimes the smartest thing that advisory firms could do or investors for that matter.

Keith Matthews: A hundred percent. what were the 20 years? you talked about the one year returns and the five year returns, but now assume that somebody followed this path for 20 years, Marcelo. What's the gap in return, approximately?

Marcelo Taboada: This is where it gets really painful. Okay. if you look at the 20 year return, trailing returns going back, as of looking back 20 years from December 31st, 2024, the 60/40 portfolio that doesn't move returned about 8%.

Okay. Whereas the tactical portfolio that moves things around returned about 5%. Yeah. that's 300 basis points of drag. Yeah. for 20 years, it doesn't sound much. But when you look at it in a graph, it's huge. Well, it's massive.

Keith Matthews: And this is one of the bizarre things about the investment industry. I think it plays to investors emotions. But very few industries, Marcel, we were talking about this just before the show. If you run a clothing business and you're producing sub quality clothing and you are charging more for it, you do not last in business. But for some reason, the investment industry can create suboptimal solutions, charge more for it and stay in business.

It makes no sense. And they're doing it because they're able to get away with it based on playing to people's investors emotions and not really showing them this type of data.

Marcelo Taboada: I think that you got it right. I think the marketing teams of the investment firms and the people putting together this funds know exactly how to manipulate human psychology. They know exactly how people's brains work and they take advantage of it.

Keith Matthews: And I'm going to go as far as saying one of the takeaways we want The listeners to be aware of is that, yes, we're talking about tactical asset allocation strategies, but we're also talking about the behavior of, could be anybody, could be an investor, an advisor, an advisory, could be anybody who's saying, we now need to move things around in your portfolio.

Marcelo Taboada: Listen, at the end of the day, there's one of the other happening. It's either the advisor going to the end investor and saying, I think we're going to move the portfolio this way. Or the individual investor is buying this fund saying this will protect me or make me more money in the long run.

Keith Matthews: It's one or the other. Or I'm going to add another one, or an investor going to their advisor and saying, I think we should do this in the portfolio because I'm worried. That's true. And then the advisor saying, okay, I'll do it for you. When the real answer could have been, or the better judgment call could have been, no, let's make sure we stick to these asset allocations. And the more we succumb to our emotions, the lower the returns are over long periods of time. Let's jump and move to risk now, Marcello.

Marcelo Taboada: Yeah. And by the way, before we move on, I gave you the 20 year number, but that's across the board. One year, three years, five years, 10 years, 15 years. There's a gap of outperformance between the tactical asset allocation and the static 60/40 portfolio. Just thought I'd mention that.

Keith Matthews: Thank you for that. That's a very good point. And the numbers we're looking at do not have the funds that didn't survive. if you add survivorship, it's got survivorship bias in it. if you add the funds that were eliminated or did not survive, the numbers are even lower.

Marcelo Taboada: And they did mention in the report that this area of the mutual fund industry or the fund industry has a very high mortality rate. that's a very good point that you raised there.

Keith Matthews: So, talking about risk now, Marcelo, for our listeners, investment strategies, sometimes people point to the performance.

Then they often also point to risk. But if I can get this risk adjusted return that's higher, it has to do with how much return am I getting per unit of some form of risk. And in this chart that we're looking at, the form of risk is volatility, how much the portfolio or the strategy goes up and down.

Marcelo Taboada: The easiest way to think about that is if you own a 60/40 portfolio and your return at the end of the year was 8% and you have one single stock that returned 8% but it moved tremendously, that investment on a risk adjusted return basis, it's taking way more risk for the level of return that it's getting.

It matters how much risk people take to get to the end point. And we don't think about this thing sometimes, but when you look at the reports, specifically the tactical asset allocation funds took more risk and they got a lower return. But the chart we're looking at essentially speaks to volatility.

Keith Matthews: Correct. There's ways of measuring. Yes. Yeah. Yeah. it is a measure. It's a statistical measure in terms of how much the portfolio goes up and down, but the irony is, is we're looking at a chart that essentially shows that they got a lower return, but the client experience was more volatility. Correct. that's like, again, it's high fees, low returns, more bumps along the way, which to me is also akin to individuals.

Forget about if they're using a tactical asset allocation. If they're just moving money around with their advisor or on their own, they're typically going to get worse returns for a higher level of anxiety too, because the bumps along the way are nerve wracking and they've got to figure out what predictions do I buy into or not, which means you're constantly thinking about what I should do with my portfolio, which is ironic because that's the exact problem that the fund is trying to solve.

Marcelo Taboada: Well, that's the end investor.

Keith Matthews: Yeah. And I'm talking about just basic investors again, creating more anxiety for themselves by moving money around and it's not a great outcome. let's talk about what caused the poor results. We've got a chart here. Which essentially shows the asset allocation between stocks, bonds, and cash. And we're able to track in the last five years, the allocations to stocks in all of these different periods. And what are some of the observations that you might make, Marcelo?

Marcelo Taboada: Well, fees, you mentioned, are a big part of why these funds are underperformed. But I think the biggest one, Keith, is that if you look at the graph, They own the wrong stuff when they shouldn't own it.

When the market's going down, instead of buying more equities, they're dumping the equities. they're missing the rebounds when the market rebounds and recovers. And you see that across the last four years. if you look at, for example, in 2022, in the third quarter of 2022, they are decreasing the amount of equities.

And that's when markets are going down. guess what? When the market does recover, you're not going to catch the wave because you have a lower allocation to equities.

Keith Matthews: So, said a slightly different way, when stocks are low and you should be buying, they're selling. They're selling going into that period.

And by the time they get their stocks back up to where they should be, it's too late. Marcelo, we're doing the complete opposite to what they're doing. when equities are low, we're not selling more equities. If anything, if we've got cash, we're buying more equities. And if clients need more money and their allocations get higher, inequities and they need a little bit of money.

That's where we take the money from. it's ironic that we have a very structured approach and we think a structured approach and we're not tooting our horn here. We're just saying this is, we think the right way to do things.

Marcelo Taboada: Yeah. I mean, it's not us saying it, right. It's an industry wide movement now that people are realizing that these strategies don't work and you see it investors are voting with their money, there's a huge jump into and flows going into passive strategies, evidence based strategies. Yeah, but that doesn't mean people are still executing it correctly. I agree, but it's way better than it was before.

Keith Matthews: Ah, you know what, now we're opening up a different can of worms here, because if you look at the do it yourself market, they're not necessarily, even though they might be using exchange traded funds.

Marcelo Taboada: Correct.

Keith Matthews: They're not doing the timing correctly. This is all about when individuals time to buy certain strategies.

Marcelo Taboada: That is true. I mean, we still have a lot of issues to solve, but I think the market is going in the right direction for funds and investors as well.

Keith Matthews: Yeah. the tax allocation fund is becoming a little less popular. Investor behaviors isn't changing. It's still not changing and this still highlights how difficult it is to get it right. Okay. we talked about that. what's the major psychology? Why are investors not able to solve this right now?

Marcelo Taboada: Well, look, I think again, the marketing teams know how the feeder greed cycle works.

They know how, people's psychology works in terms of the market and the behavioral biases that we have. They know that there's an allure to doing something. And I think there's also evolutionary, right? Like, I mean, If you go back to hunting and gathering times, Keith, if you had people who was passive about just their surroundings, you wouldn't eat, your tribe wouldn't thrive.

I think that's very ingrained in our DNA when it comes to the world, right? our DNA rewards being distracted, rewards taking action, because first of all, if you weren't. attuned to your surroundings. You could be eaten by a very large animal. And if you weren't chasing stuff or being super active, when your environment changed, your tribe wouldn't eat.

It wouldn't thrive. You wouldn't pass on your genes. I think there's a lot of that still in our brains.

Keith Matthews: Wow. You just brought in thousands of years of history into this. Well, that's good. I mean, I think that's exactly what it is. Yeah. Yeah. No, it's very good. I mean, I'd love your answer. I mean, the classic response is it's fear of individuals chased because They fear missing out and they hide when they're worried about harm.

It's an amazing concept. And that's why individuals will still trade. You're absolutely right. Marcello, one of the things that gets individuals in difficulty with this idea of either trading or assuming that somebody can trade for you, whether it's an advisory firm or a tactical asset allocation strategy, is this notion of predictions.

And we've got a few slides that we're looking at right now, which really talk about this idea of predictions, but let's use some live case scenarios. And it just goes to show you the power of predictions. And I guess our warning would be to make sure when you're hearing predictions from firms that you feel are experts, really take it with a grain of salt here, because they're often wrong.

Marcelo Taboada: I always think about this when friends. Are not clients or we necessarily don't have this specific conversations about investments. They send me links of banks saying, sell everything. Everything's going to crash. I always chuckle when I read those because we know it's futile, right?

Keith Matthews: We had JP Morgan, Fidelity and Goldman Sachs predictions here of last year in end of 2023 going into ‘24. And of course, 2024 was a strong market. what are the kinds of predictions that we were hearing at the very beginning of 2024?

Marcelo Taboada: let's take JP Morgan, huge bank in the United States. In December of 2023. They say we expect downside for equities from current levels.

Keith Matthews: Okay. I read that. I go, J.P Morgan's a large bank. They must know what they're doing. They expect it. I should sell stocks. What did the S&P500 produce last year in 2024?

Marcelo Taboada: About 24% in USD, about 35% in Canadian. Absolutely. they were 100% wrong. And did they change their mind halfway through? in June of 2024, they say, quote, the U.S. economy should continue to provide a rising tide to support most investment boats for the rest this year and into 2025, end of quote.

Keith Matthews: Yeah, here you've got, this is typically what happens. And I remember this from my bond trading days. This would drive me crazy 30 years ago. Reputable firms coming up with a prediction and then changing it six months later, but it's too late, you lost the movement.

Marcelo Taboada: Okay, listen to this. Fidelity, which is one of the largest asset management firms in the world. In November of 2023, they say, quote, Barring something extraordinary, next year we expect to see the economy finally turn lower. June of 2024, they say, quote, What we're seeing in the U.S. is a resilient expansion.

Well, no kidding. But their statements encourage people to take action. Goldman Sachs, I'll give you the last one, November 2023, they say, quote, the current starting point will limit the potential appreciation for the benchmark U.S. equity index in 2024. Again, remember, it returned 35% in Canadian, right?

October of 2024, they say the equity market sell off is canceled and a year end rally is starting to resonate with clients shifting from. Hedging from the left tail to the right tail.

Keith Matthews: Yeah, telling. this is a classic we've just identified and this is all factual. We've identified three major leading experts on their views on equities and how difficult it is.

It would be for an investor, if you're listening to this and trying to figure out what to do. And the actions that you could take might be, produce a whole lot less value than you think. the second to last chart we're going to look at here, we're forecast versus reality for 2024. we just have, Marcel, maybe just give a summary, but we've got 15 advisory firms making predictions on the S&P500 for last year.

And the S&P500 last year, again, produced 24% U.S. return in U.S. dollars, higher in Canadian, but. What were the ranges of various different forecasts?

Marcelo Taboada: Yeah. I'll give you a few names that we all know. Goldman Sachs predicted that the S&P500 was going to return 8%. Deutsche Bank around the same, 8%. RBC came in at 5%. Barclays came in at about 1%. And There's a lot of companies, you know, Wells Fargo predicted a -3, -4 return in 2024. And the worst was JP Morgan. Actually, they said that the S&P500 was going to be anywhere between minus 10% and minus 15%.

There you have, Professional money management firms making predictions. They have people who study this stuff 24/7 and they were all wrong.

Keith Matthews: Yeah, the other one I'm going to point to is Cantor Fitzgerald, which suggested a minus seven, minus eight. And for our listeners, I just learned about this this weekend. Cantor Fitzgerald CEO was Howard Lutnick.

And Howard Lutnick is now, he's the Secretary of Commerce in the United States in charge of tariffs. And so, you know, again, it just goes to show you how hard it is to predict and, and how people put experts up on a podium. And the reality of it is they just can't get it right. to think that your advisor can get it right, That the firm you're dealing with can get it right, that your large institution you're dealing with can get it right, I think is a stretch and this, we want to bring this to everyone's attention because it is valid, it is important.

Marcello, we're in the wrap up right now. What are your takeaways? What should people do and what should people not do?

Marcelo Taboada: Let's finish this way. Look, I think the first one is don't trust predictions. We know historically, actually, Margaret MacMillan, which is a famous historian, had a great article in Foreign Affairs this weekend.

And she said two things that resonated with me. She said, it is incredibly difficult to predict. the impact of things when we're living in them because we just don't know how things can change quickly. she gave the example of the assassination of Franz Ferdinand, Archduke in Sarajevo in 1914. That ended up escalating a conflict that ended up resulting in World War I and 16 million people died.

And a lot of people will say that World War II was a direct relation to of World War One. And then she goes into a more modern example and says, think about the iPhone. When the iPhone came out, nobody could predict what we're living now today and seeing the effects of technology in children's brain and suicide rates and the impact it has on people and the ability to concentrate.

Predicting is just very hard. that would be my number one takeaway. And number two, it would be, sometimes it sounds counterintuitive to the way our brain is wired, but doing nothing is the most sensible approach. And just wrapping your head around that, I know it's hard, but if we are able to do it, I know the outcomes will be better.

Keith Matthews: Well, those are great stories, fantastic stories, Marcello. And the quote that I'm about to use, we've used before in one other show, where often you could consider a portfolio is a bar of soap.

The more you touch it, the smaller it gets. And this speaks to the idea of, we for sure believe that every single portfolio needs to be set up with a long term strategic asset allocation, allocating to various asset classes, and then staying the course with rebalancing, with cash flows coming in or cash flows leaving, and infrequent rebalance. But that is the key to long term success. Set your portfolio up, stay away from the noise, and focus on planning, tax, and the things you can control.

We cannot control the market. it's a perfect time right now. We do have some worry in the market as Canadians with regards to tariffs and they are legitimate and hopefully we'll be able to resolve a variety of different things.

We have to get stronger. We've had the last week's show was just on that, but we cannot fall prey to trying to outthink the market and make too many major bold moves. Couldn't agree more. So, thank you very much, Marcel, for sharing your thoughts. That was a great find that you had last week when you found the latest release.

We always to bring this to our listeners attention, thank you much, and until next time, take care.

Keith Matthews: Hey, Marcello, as an afterthought, you and I were just talking, we wanted to encourage our listeners to share the podcast with friends and family.

Marcelo Taboada: What else did we want to have our listeners do? we are very proud of the show we're producing. When we set up to do this podcast, Keith, we wanted to reach out. First of all, our clients give them content that they enjoy, and we want to reach as much people as we can. if you've been enjoying the show, please comment, review, share with someone that you care about the show, and that would help us tremendously.

Keith Matthews: Beautiful. Thank you very much, folks. We'll see you next week. Thank you.

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