BlackRock

The Essentials of

Global Tactical Asset Allocation

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Global Tactical Asset Allocation Modern Global Macro

Global Tactical Asset Allocation (GTAA) strategies have been delivering significant investment performance, diversification and capital efficiency benefits for institutional investors since GTAA emerged around ten years ago. As many pension funds increase their exposure to riskier assets in an attempt to improve long-term investment returns, interest in GTAA strategies is growing.

The attraction of GTAA in the current financial climate is illustrated by the fact that more UK pension funds (6.2%) expect to increase their allocation to GTAA strategies than any other alternative investment strategy.* In this guide, we summarise the features that contribute to the success of GTAA strategies and how investors can put these strategies to work in their portfolios.

*Source: Mercer, European Asset Allocation Survey, April 2010

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What is GTAA?

GTAA is a type of multi-asset investment strategy that focuses on adding value via market selection, rather than through individual security selection. GTAA and 'global macro' strategies are one and the same, with their broad, top-down approach to forecasting and investing in global asset markets.

GTAA strategies typically include global equity, currency, bond and commodity market selection, international industry or sector selection, as well as market timing components. They are frequently used either as standalone diversified sources of alpha or as an 'overlay' to the international assets in an investor's portfolio.

GTAA is very different from strategic asset allocation, where the focus is on the long-term average relationships between asset classes to set benchmark allocations. GTAA developed out of traditional balanced management (see the brief history box) and today these strategies are at the forefront of sophisticated investment thinking and implementation, employing robust risk management and quantitative methods.

A brief history of GTAA:

- In the 1970s, balanced mandates were popular but their performance often disappointed. Within these strategies, asset allocation was typically an afterthought to the management process.

- Tactical asset allocation (TAA) was a step forward, with positions taken to reflect the investment manager's views on the outlook for equities, bonds and cash. TAA strategies were low turnover, directional and long-only. However, these constraints limited the ability to translate manager insights into additional performance for clients.

- TAA strategies have evolved over the last 10-15 years into GTAA, or 'global tactical asset allocation'. This is also known as global macro. GTAA is characterised by offering a broader set of investment decisions to the manager. This greater 'breadth' allowed GTAA portfolios to include international equities, foreign exchange or positions based on relative value views.

- Today's modern GTAA approach joins the benefits of expanded breadth with more efficient implementation of investment insights, whether employing leverage or short positions. As a result, modern GTAA can provide better investment performance than earlier versions of the strategy.

Benefits of GTAA

The key benefits of GTAA are the delivery of a diversified and lowly correlated source of alpha, portfolio diversification, capital and operational efficiency, and scalability of risk.

Alpha generation: GTAA managers have outperformed other asset classes through a variety of market conditions and during difficult trading environments. Figure 1 shows that among a universe of GTAA managers, the upper quartile generated annualised investment returns of 14.0% over the ten years to June 2010. Over the same period, upper quartile US large cap equity and fixed income managers returned 5.0% and 7.3% annually, respectively. Figure 2 highlights that even during the five years from June 2005, when the effects of a credit crisis were more pronounced on financial markets, GTAA managers similarly outperformed equity and fixed income managers.

Figure 1. Historical performance of GTAA (2000 to 2010)

	GTAA annualised return (%)	US large cap annualised return (%)	US fixed income annualised return (%)
Top quartile manager	14.0	5.0	7.3
Median manager	4.6	1.9	6.9

Source: Mercer. Based on Mercer's database of GTAA managers over the ten-year period ended 30 June 2010.

Figure 2. Historical Performance of GTAA (2005 to 2010)

	GTAA annualised return (%)	US large cap annualised return (%)	US fixed income annualised return (%)
Top quartile manager	10.3	3.9	7.3
Median manager	5.2	2.0	6.8

Source: Mercer. Based on Mercer's database of GTAA managers over the five-year period ended 30 June 2010.

Portfolio diversification: GTAA strategies exhibit low correlation to most major asset classes. Figure 3 quantifies these correlation characteristics and shows that the strategy can yield diversification benefits when added to a sample portfolio comprised of traditional assets. A correlation of 1.0 indicates full correlation while a score of 0.0 indicates no correlation at all. GTAA can be seen to be essentially uncorrelated with several equity and bond indices. Moreover, since the active risk in institutional portfolios is largely focused around asset allocation, allocations to the strategy will diversify institutional investors' portfolios further and so should reduce active risk.

Figure 3: GTAA largely uncorrelated with other asset classes

Equity/Bond indices	Correlation
MSCI World	0.05
S&P 500	0.03
FTSE 100	0.04
JP Morgan Government Bond Index (GBI Global)	0.05

Source: Credit Suisse, based on period between March 2005 and June 2010.

Capital and operational efficiency: Accessing tactical asset allocation through a derivatives-based GTAA strategy is more efficient than implementing tactical asset allocation decisions by buying and selling physical securities and shifting allocations to and from existing managers. Using derivatives is faster, more cost-effective and operationally easier than buying and selling physical securities to implement views. Within the derivatives marketplace, futures offer the benefit of using a centralised clearing house to minimise counterparty risk, while over-the-counter swaps can be tailored around different index exposures and time horizons.

Scalability of risk: GTAA has the ability to scale (up or down) a portfolio's position level exposures in order to achieve a given level of active risk and return. As GTAA is implemented using derivatives, only a modest proportion of the portfolio's market value will be needed as margin to fund each portfolio position, thereby allowing a more efficient use of capital. Indeed, GTAA funds typically offer active risk that is lower than traditional long-only equity strategies, with a more diverse opportunity set in which to add alpha.

Figure 4: Typical elements of a GTAA strategy

Equity	Developed equity market selection Emerging equity market selection Industry-sector selection Timing component: equity versus cash
Fixed income	Sovereign bond market selection Industry-sector selection Timing components: – Duration and yield curve shape – Credit
Currency	Developed market selection Emerging market selection
Commodities	Active commodities, with exposure across energy, metals, agriculture
Other components	Opportunistic macro-investments

Source: BlackRock

How GTAA fits into your portfolio

There are three ways that institutional investors typically use GTAA strategies to increase the return on their portfolio while adding little portfolio risk.

1

Alternative investment
As an alternative investment, a global macro hedge fund or absolute return vehicle is often designed to outperform cash with low correlation to other alternative investments and major market indices.

2

Portable alpha/Overlay
Global macro funds aim to port alpha onto any asset class where alpha is typically difficult to capture, or as an overlay on the entire portfolio. Portable alpha aims to help close the gap between the pension fund's expected return and the target return. In this capacity, clients can structure their GTAA investment so as to leave the pension fund policy mix unchanged.

3

Next generation asset allocation
GTAA is one of the tools available to create more efficient means of capturing active returns from asset allocation. Traditional tactical asset allocation models tend to suffer from a very restricted opportunity set, typically comprising of only stocks, bonds and cash. GTAA strategies can provide trustees with a significantly expanded range of investment options such as taking net short positions and obtaining exposure to currency markets. The much greater diversification benefits available under GTAA can also deliver more consistent active returns for pension funds.

Accessing the benefits of GTAA strategies

Pension funds of all sizes and types can incorporate GTAA into their portfolios. There is a growing consensus among consultants and managers that pooled funds are generally more suitable for institutional investors as they offer access to a long-short strategy in a limited liability format. This is particularly so for smaller pension funds. Pooled funds cap any losses at 100% of the original investment. They also protect funds from direct exposure to the volatility or administrative burden associated with derivatives contracts.

Global macro managers benefit from a number of advantages common across most hedge fund styles. In contrast to traditional long-only managers, they can profit from both rising and falling markets and can use leverage on a selective basis in order to magnify opportunities. The dispersion of investment outcomes also makes global macro attractive as a strategy style, especially in terms of providing greater diversification.

The liquidity of global macro managers' holdings should be reflected in the liquidity that they offer their clients. The recent financial crisis has amplified the importance of employing an

active manager that can cope with extremely tough liquidity conditions, as liquidity pressures can force some managers to impose restrictions on withdrawals during times of heightened market volatility. Investors need to feel comfortable that the manager has demonstrated their ability to incorporate liquidity management into their broader management of risk.

Summary

GTAA strategies tend to provide investors with an excellent source of diversified alpha, although investment performance is only part of the story. An increasing number of pension funds find that the strategy can provide a valuable addition to a portfolio as a risk management tool. Indeed, managers with a robust operational infrastructure and strong risk management process are well placed to deliver GTAA most effectively, especially during periods of extreme market stress.

Many pension funds have experienced worsening funding ratios in recent years and are reviewing their investment strategy to ensure the fund takes the most appropriate approach to closing any funding shortfall. A growing number of institutional investors are increasing allocations to GTAA as they strive to achieve the required level of risk-adjusted long-term returns more effectively. Many funds are drawn to the approach as a means of trying to reduce active risk significantly through more diversified portfolios. Investors are finding that traditional approaches to portfolio diversification can often struggle to provide their expected benefits in difficult market conditions.

GTAA strategies can provide pension funds with an efficient and flexible means of altering risk profiles and employing capital. As the strategy is implemented using derivatives, the fund only has to provide margin for each portfolio position, freeing up capital for additional investment. It also typically provides investors with exposure to emerging markets, commodities, fixed income, currencies and other asset classes. Consequently, as an increasing number of pension funds allocate more capital to alternative asset classes, GTAA can provide an effective means of gaining such exposure.

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