2020 case study: Strengthening global tactical asset allocation in a tumultuous time

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Published
2/25/2021

Discover our framework for tactical asset allocation and uncover its potential benefits in a period of shifting monetary policy.

In any market environment, tactical asset allocation strategies can provide a critical benefit—an uncorrelated and dependable source of alpha. As investors evaluate their options for return generation in a world of expected low nominal returns, such strategies can be a useful tool in portfolio construction and management.

Tactical asset allocation strategies may, when well structured, enhance strategic asset allocation returns by actively rotating portfolio exposures among specific asset classes when they offer value or become expensive. As markets are increasingly volatile, this flexibility becomes more important in managing risk and capturing opportunities. Last year was a case in point—a period in which traditional statistical quantitative models were less effective, while first principle frameworks enhanced our global tactical asset allocation (GTAA) process.

Markets moved with breathtaking speed in 2020. In 33 days, the S&P 500 plunged 34% from market peak to trough, bottoming in late March and hitting a new all-time high 140 days later. This round trip was 10 times faster than the experience in the 2008 global financial crisis (GFC) and 28 times faster than the 1929 crash and subsequent Great Depression.

Unprecedented market speed led to a significant dispersion of outcomes for investment managers and asset allocators. Quantitative strategies relying on historical models struggled to capture event-specific turning points such as the outbreak of the COVID-19 pandemic, nation-wide lockdowns and news around successful coronavirus vaccines. Effective strategies adjusted to cyclical turning points driven by aggressive policy stimulus and captured shifting secular themes such as work-from-home technology.

We believe 2020 underscored the value of global tactical asset allocation. This paper describes the potential benefits of GTAA strategies, outlines the concept of a contingent claims framework in active asset allocation and highlights key tactical shifts during 2020 in our GTAA portfolios. The use of a contingent claims framework—and the related notion of distance to default—was critical for our GTAA strategies in 2020, allowing us to nimbly rotate across a number of asset classes. This framework is also proving effective in the current environment of elevated asset prices, high sovereign debt levels, ultra-low or negative interest rates and new monetary policy paradigms.

The power of a contingent claims framework

The contingent claims framework is one of many quantitative and fundamental tools our Multi-Asset Solutions team deploys in managing GTAA portfolios. The framework, as presented in **Exhibit 1**, is typically used to understand the default probability of an individual firm and manage idiosyncratic credit risk. Below, we define three key terms:

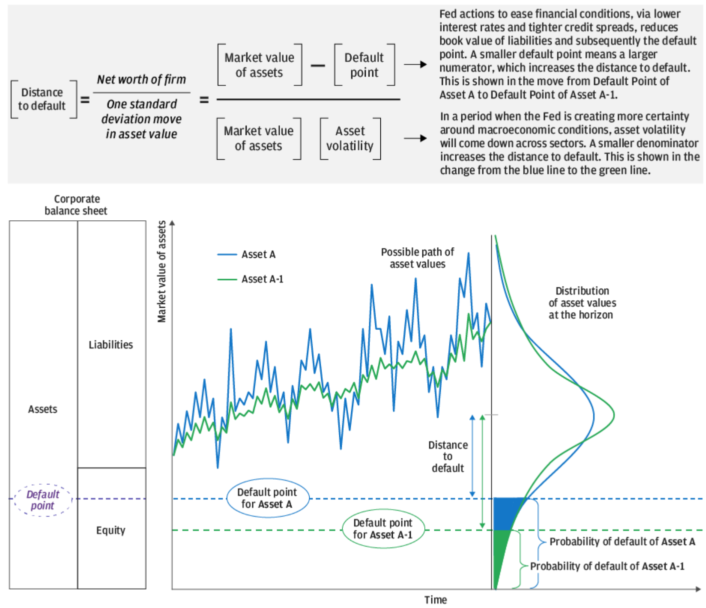
- **Default probability**—The likelihood a firm will have insufficient assets to cover liabilities. Default probabilities change as a firm's assets and liabilities change.
- **Default point**—The point at which a firm's assets can no longer cover its liabilities. Typically, the default point is somewhere above a firm's book value of liabilities.
- **Distance to default**—This is the number of standard deviations the asset value is from the default point. If the distance to default *increases*, the default probability *decreases*.

If the distance to default increases, investors should be willing to pay more for the firm's debt and equity, all else equal—this is the crux of the contingent claims framework.

To determine default probability and distance to default, we look at three variables: market value of assets, book value of liabilities and asset volatility. Changes to these inputs can modify the default probability of the firm—and subsequently the value of the firm's publicly traded equity or debt. In practice, options pricing is used to estimate asset volatility from the volatility of publicly traded equity. Conceptually, asset volatility can be thought of as variability in the growth of a firm's assets (e.g., food producers will have much lower asset volatility than infant technology companies).

Exhibit 1: Contingent claims framework

If the distance to default increases, investors should be willing to pay more for the firm's debt and equity, all else equal



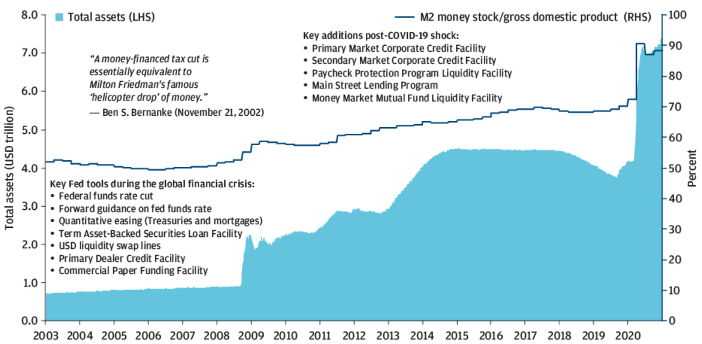
Source: Moody's KMV, "Modeling Default Risk," Crosbie and Bohn (2003), J.P. Morgan Asset Management. Shown for illustrative purposes only.

When structural forces affect default probabilities across almost all firms and sectors, the contingent claims framework can be particularly useful for a multi-asset allocator—especially in periods of macroeconomic stress, as was the case in 2020.

Certainly, central bank intervention has become more aggressive during the coronavirus pandemic when compared with the 2008 financial crisis. Following an unprecedented policy response from the Federal Reserve (Fed), which increased liquidity and supported asset values, asset volatility was reduced. In particular, U.S. monetary policy stimulus (a balance sheet now totaling USD 7 trillion, including asset purchases of both high quality and default-prone assets) has joined forces with ~ USD 2 trillion in fiscal stimulus (with more on the way). Distance to default increased and default probabilities decreased, as expected. **Exhibit 2** details the modern evolution of the Fed's policy response—including prescient comments from former Fed Chair Ben Bernanke as early as 2002. We believe expansive monetary and fiscal policy will have important implications for financial markets in the years ahead. The contingent claims framework will remain a useful tool as policy and markets evolve.

Exhibit 2: The Federal Reserve balance sheet and crisis toolkit

The size and scope of emergency policy measures have evolved over time



Source: Board of Governors of the Federal Reserve System (US), FRED, J.P. Morgan Asset Management; data as of December 31, 2020. Shown for illustrative purposes only.

Total Assets: Board of Governors of the Federal Reserve System (U.S.), Assets: Total Assets: Total assets (less eliminations from consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WALCL, February 9, 2021.

M2 money stock/gross domestic product: Board of Governors of the Federal Reserve System (U.S.), M2 money stock [M2], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/M2, February 9, 2021.

Tactical asset allocation in 2020: The contingent claims framework in practice

In a tumultuous year, a contingent claims framework helped us capture some of the market opportunities that were on offer in 2020.

Exhibit 3 summarizes the portfolio exposures of one of our flagship GTAA accounts. Coming into the pandemic, we expected the global economic cycle to extend into 2021 with no major fiscal imbalances present. We expressed this view in overweights to equities and credit. As COVID-19 quickly evolved into a global pandemic, and with a 25% overnight drop in oil prices on March 9, we began to cut risk. Among our key decisions to mitigate risk:

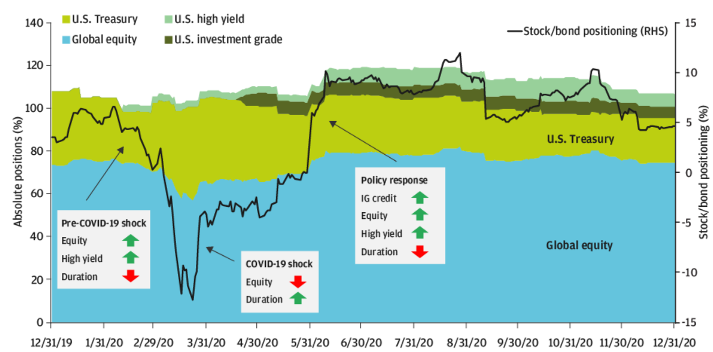
- Adding two years of portfolio duration
- Reducing public equity exposure
- Selling small cap equities to hedge increasingly illiquid credit positions

On March 23, when Chair of the US Federal Reserve System (Fed), Jerome Powell, announced the deployment of the Fed 13(3) facilities to further extend credit, we believed the market was set up for an inflection point despite all of the ongoing uncertainty. The Fed announcements created the potential for more certain macroeconomic outcomes and increased liquidity in financial markets, both of which had major implications for a contingent claims framework.

As a result, we shifted gears and started to add back credit risk in April via investment grade (IG) corporate bonds—intentionally focusing on the top of the capital structure. Default probabilities were coming down uniformly, we believed, and credit spreads looked attractive after blowing out in March. Higher quality corporate bonds were a logical first step back into risk, as the path of outcomes for lower quality companies appeared less certain. As the market environment continued to stabilize, we followed a playbook similar to the one we used in the financial crisis. We gradually moved further down the capital structure, adding high yield and then equities throughout May and June as the most dire left-tail scenarios became increasingly less likely. By the middle of June, we were 4% overweight equities and 13% overweight credit (Exhibit 3).

Exhibit 3: Portfolio positioning in a GTAA portfolio, January–December 2020

We made a series of key tactical asset allocation moves in 2020



Source: J.P. Morgan Asset Management; data as of December 31, 2020. Shown for illustrative purposes only.

Through the second half of 2020, we made several other impactful trades, including:

- Rotating from U.S. large caps to small caps to reflect a shift from COVID-19 winners to cyclical "reopening" stocks
- Staying underweight the U.S. dollar, given the magnitude of monetary and fiscal easing in the U.S. compared with other developed and emerging economies

As we made many portfolio adjustments throughout the year, the contingent claims framework proved critical in allowing us to capture event-specific turning points and understand broad market risk.

Global tactical asset allocation: Portfolio flexibility, market volatility

Looking ahead, we will consider a broad array of inputs—a contingent claims framework key among them—to construct a GTAA strategy that can best meet an investor's risk and return goals. Flexibility has always been a defining characteristic of our global tactical asset allocation process.

While we will continue to utilize quantitative and fundamental models to identify opportunities, we will maintain flexibility as markets move at a rapid (if not blistering) pace. We believe the most effective GTAA managers will use both traditional and nontraditional frameworks to identify appropriate and attractive asset class returns while staying true to particular return targets and risk parameters.