Tactical Asset Allocation with ETFs

Investors are seeking ways to thrive in a highly volatile environment for stocks and bonds. An investment process that can identify current market conditions and position portfolios accordingly can potentially help investors navigate volatile market environments. The case for tactical asset allocation (TAA) with exchange traded funds (ETFs) rests on three beliefs. First, asset allocation is the most important decision in determining portfolio returns. Second, the TAA market may be less efficient than the market for individual securities, enabling portfolio managers to identify and exploit mispricings in the market. And finally, using ETFs for TAA enables cost-effective diversification across asset classes.

What is Tactical Asset Allocation?

In a strategic allocation approach, asset class weights are rebalanced to target weightings according to fixed rules aligned with the portfolio’s investment strategy and risk profile (a fixed 60% stock/40% bond mix, for example). The rebalance is done without any view of market issues or opportunities.

In a TAA approach, the manager starts with strategic weights but then increases exposure to asset classes the manager believes to be attractive relative to other asset classes. Therefore, TAA is a form of active management. Most people think of picking individual stocks or bonds when they hear the term “active management.” However, TAA focuses on decisions about asset classes. The goal of a tactical approach is to take advantage of market inefficiencies at any given time by increasing or decreasing exposure to asset classes that may have become mispriced.

Why Tactical Asset Allocation?

TAA offers the potential for investors to outperform in both downmarkets and up-markets. An investor could have used TAA to potentially reduce losses in the down-market of late 2008 and early 2009 by overweighting cash or US Treasuries. Similarly, an overweight to US stocks would have enhanced portfolio returns during 2010’s up-market. TAA can potentially help investors avoid the worst of market downturns and outperform as markets recover.

Studies show that asset allocation plays a greater role than security selection in determining investment returns. Selecting which mix of investment classes to invest in — and when to change the mix — can explain 90% of the variability of portfolio returns over time. This is a good reason to focus more attention on asset allocation and less on individual stock selection.

Academic research also suggests that TAA is an effective source of alpha because markets are less efficient at the asset class level than they are at the securities level. This relative inefficiency at the asset class level is due to several factors. For starters, it is more difficult to understand changes in fundamental values at the asset class level when compared to valuing individual securities. In addition, the impact of economic, monetary and fiscal policy, as well as speculative booms and busts add complexity to analyzing the value of the aggregate market. In short, it is more difficult to place accurate valuations on asset classes than on individual securities because it is harder to capture the drivers of performance at the asset class level.

Selecting a TAA Portfolio

Performance among TAA portfolios may vary greatly based upon their individual investment goals. A conservative TAA portfolio could be tied closely to a benchmark. For example, a 60% stock/40% bond portfolio might be allowed to vary no more than 10% from its benchmark. In contrast, an absolute return TAA portfolio might have no constraints, so it could be completely unrepresented in major asset classes, when that appears beneficial to enhance the overall return of the portfolio. TAA portfolios can fall along different points between these two extreme ends of the spectrum.
Choosing the right portfolio would depend on the investor’s risk tolerance as well as the role of the TAA portfolio. Some investors use TAA portfolios as a single-portfolio solution, providing full market access with the potential to capture additional return. Others use TAA portfolios as one element of a more complex portfolio, where the TAA portfolio might be complemented by more targeted funds, depending on the investors’ need for protection in declining markets, excess return or other enhancements.

In addition, it’s important to select a TAA portfolio with the right time horizon. At one extreme, some TAA portfolios function almost like day traders. At the other end of the continuum, some may use the business cycle as their time horizon. Risk and returns may vary considerably depending on the portfolio’s time horizon. For example, State Street Global Advisors (SSGA), the investment manager for the SPDR SSGA Active Asset Allocation ETFs, believes that six to nine months is the most appropriate time horizon.

Why SPDR ETFs?
SSGA, the investment manager for SPDR SSGA Active Asset Allocation ETFs, is a large investment management firm that has dedicated resources to TAA. The Investment Solutions Group (ISG) within SSGA manages the SPDR Active Asset Allocation ETFs. ISG began managing US asset allocation portfolios in 1982 and global asset allocation accounts in 1989. The group has managed tactical portfolios for more than 20 years and manages over $240 billion in asset allocation strategies for investors around the globe.

The team of over 70 investment professionals has an average of more than 15 years experience in the investment management industry. Previously, SSGA’s tactical portfolios were only available to the largest, most sophisticated institutional investors. With the advent of the SPDR SSGA Active Asset Allocation ETFs, this institutional grade approach to investment management is now available to investment advisors and their clients.

The team applies a disciplined, systematic process using inhouse research and portfolio management staff in nine locations around the world. It combines a three-step investment and risk management process with fundamental oversight by seasoned investment professionals. This depth and breadth allows ISG to create portfolios for various risk and return profiles, with tailored investment objectives.

**Step 1 — Market Regime Identification**

Step one of the ISG investment process begins with SSGA’s Market Regime Indicator (MRI). The SSGA MRI generates forward-looking information based upon three market risk sentiment factors: equity index implied volatility, currency pairs and spreads on risky assets. It then classifies current market conditions into one of five potential market environments: crisis, high risk aversion, normal, low risk aversion and euphoria. The portfolio’s risk budget is then adjusted based on the identified risk environment. For example, in periods of high risk aversion, the portfolio may take on less risk than under normal circumstances. Figure 1 shows risk sentiment during various market conditions through September 30, 2015.

**Figure 1: Market Regime Indicator**

[Graph showing market regime indicator from June 2013 to September 2015]

Source: SSGA, Investment Solutions Group, as of 9/30/2015.
Step 2 — Evaluation

To find market inefficiencies, a quantitative process scores more than 100 global asset classes, including broad asset classes, sub-asset classes and components of sub-asset classes. A proprietary model uses multifactor analysis to objectively process large amounts of data that have predictive value. Analysis includes valuation, momentum, sentiment and macroeconomic factors. This process provides forward-looking rankings of asset class performance and an initial target allocation among stocks, bonds, commodities and cash.

Step 3 — Portfolio Construction

The broad investment themes must be turned into specific portfolio positions for each risk profile. Once the MRI identifies the current risk appetite in the market, the portfolio management team adjusts the tactical active risk budget accordingly. The team then incorporates the quantitative scores, as well as the fundamental views of the investment team. Lastly, the global investment team meets at least monthly in asset class teams and regional groups to review the quantitative model outputs and consider variables outside the models that may be influencing markets. This incorporates the team’s experience, global perspective and local market knowledge. In addition to this monthly process, ad-hoc meetings are held whenever the investment environment dictates. In general, each portfolio will trade between 12 to 18 times per year.

The positions determined in the portfolio construction phase are then implemented through a fund-of-funds investment approach that primarily invests in SPDR ETFs, but also includes other exchange traded products (ETPs), as the underlying funds. The development of ETFs has made a full range of asset classes available at a relatively low cost, while facilitating broad diversification within the portfolios. The process continues with the ongoing monitoring of each portfolio’s composition and performance, identification of undervalued or overvalued assets and making any necessary adjustments to the portfolio.

Risks of Tactical Asset Allocation Using ETFs

Investors in these funds seek to take advantage of a TAA approach that has the potential to identify and exploit mispricings in the market. Additionally, these funds implement portfolio decisions through the use of ETPs as the underlying investments. Accordingly, they run the risks associated with using ETPs and active management.

Exchange Traded Products Risk — the funds are subject to the same risks as those associated with the direct ownership of the securities represented by the ETPs in which the funds invest.

Management Risk — the funds are actively managed, and therefore are subject to the risk that the investment selected by the portfolio manager may cause the portfolio to underperform relative to its benchmark or other funds with a similar investment objective.

Affiliated ETP Risk — Because the funds invest primarily in SPDR affiliated products (and the fund manager receives the underlying management fees), there exists a potential conflict of interest in selecting the affiliated ETPs. In addition, the fund manager may be influenced by the effect on an affiliated ETF when determining whether to purchase or sell shares in that affiliated ETP.

Conclusion

Tactical asset allocation goes beyond simple stock versus bond decisions. By applying an investment process that takes into consideration various market conditions over a wide range of asset classes, TAA has the potential to identify and exploit mispricings in the market. In addition, the ability to use ETPs as the underlying investments in a TAA portfolio can provide a cost effective, diversified approach to asset allocation. The SPDR SSGA Active Asset Allocation ETFs offer a disciplined, systematic approach to TAA and implements these investment decisions through ETPs to help investors navigate various market conditions.

2 Ibid.
4 Alpha is the excess return relative to the return of the benchmark.
5 SSGA, as of 3/31/2015.
Tactical Asset Allocation with ETFs

ssga.com | spdrs.com

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Important Risk Information

ETFs trade like stocks, are subject to investment risk, fluctuate in market value and may trade at prices above or below the ETF’s net asset value. Brokerage commissions and ETF expenses will reduce returns.

The views expressed in this material are the views of Global Product & Marketing Group through the period ended September 30, 2015 and are subject to change based on market and other conditions.

As with all investments, there are certain risks of investing in the ETFs, and you could lose money on an investment in the ETFs. Because the ETFs invest substantially all of their assets in underlying funds, they are subject to substantially the same risks as those associated with the direct ownership of the securities in which those underlying funds invest. These risks include risks to certain types of securities or investment instruments (e.g., equities, fixed income, convertible and preferred securities, high yield securities, US government securities, mortgage-related securities or commodities), certain regions (e.g., developed or emerging market foreign countries) and certain sectors or industries (e.g., agriculture, energy, metals and mining or real estate). The risks specific to an investment in a SPDR SSGA Active Asset Allocation ETF depend on which underlying funds the ETF’s assets invest in and how the ETF’s assets are allocated among the underlying funds.

Risks associated with investing in the natural resources sector include; large price volatility due to non-diversification and concentration in natural resources companies.

Risks associated with equity investing include stock values which may fluctuate in response to the activities of individual companies and general market and economic conditions.

Investing in REITs involves certain distinct risks in addition to those risks associated with investing in the real estate industry in general. Equity REITs may be affected by changes in the value of the underlying property owned by the REITs, while mortgage REITs may be affected by the quality of credit extended. REITs are subject to heavy cash flow dependency, default by borrowers and self-liquidation. REITs, especially mortgage REITs, are also subject to interest rate risk (i.e., as interest rates rise, the value of the REIT may decline).

Increase in real interest rates can cause the price of inflation-protected debt securities to decrease. Interest payments on inflation-protected debt securities can be unpredictable.

Because the SPDR SSGA Active Asset Allocation ETFs are actively managed, they are therefore subject to the risk that the investments selected by SSGA may cause the ETFs to underperform relative to their benchmarks or other funds with similar investment objectives.

Actively managed ETFs do not seek to replicate the performance of a specified index.

Foreign investments involve greater risks than US investments, including political and economic risks and the risk of currency fluctuations, all of which may be magnified in emerging markets.

Commodities and commodity-index linked securities may be affected by changes in overall market movements, changes in interest rates, and other factors such as weather, disease, embargoes, or political and regulatory developments, as well as trading activity of speculators and arbitrageurs in the underlying commodities.

Bonds generally present less short-term risk and volatility than stocks, but contain interest rate risk (as interest rates rise bond values and yields usually fall); issuer default risk; issuer credit risk; liquidity risk; and inflation risk. These effects are usually pronounced for longer-term securities. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

SSGA uses quantitative models in an effort to enhance returns and manage risk. While SSGA expects these models to perform as expected, deviation between the forecasts and the actual events can result in either no advantage or in results opposite to those desired by SSSGA. In particular, these models may draw from unique historical data that may not predict future trades or market performance adequately. There can be no assurance that the models will behave as expected in all market conditions. In addition, computer programming used to create quantitative models, or the data on which such models operate, might contain one or more errors. Such errors might never be detected, or might be detected only after the Portfolio has sustained a loss (or reduced performance) related to such errors. Availability of third-party models could be reduced or eliminated in the future.

The Fund is actively managed and may underperform its benchmarks. An investment in the fund is not appropriate for all investors and is not intended to be a complete investment program. Investing in the fund involves risks, including the risk that investors may receive little or no return on the investment or that investors may lose part or even all of the investment.

Asset Allocation is a method of diversification which positions assets among major investment categories. Asset Allocation may be used in an effort to manage risk and enhance returns. It does not, however, guarantee a profit or protect against loss.

Frequent trading of ETFs could significantly increase commissions and other costs such that they may offset any savings from low fees or costs.

Diversification does not ensure a profit or guarantee against loss.

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