A PRACTICAL GUIDE TO TACTICAL INVESTING

WHAT IS TACTICAL INVESTING?

Tactical investing means actively managing a portfolio with the goal of improving that portfolio's risk-reward characteristics. This goal is often achieved by using a systematic, repeatable investment process that eliminates emotion from investment decisions and focuses on reducing the downside risk inherent in investing.

WHY BE TACTICAL?

Your clients care deeply about protecting the money they have worked hard to accumulate over the years. Your clients also want to see that savings grow. Tactical strategies can help you and your clients stay invested for the long-term by reducing downside risk and providing ample opportunity for upside capture.

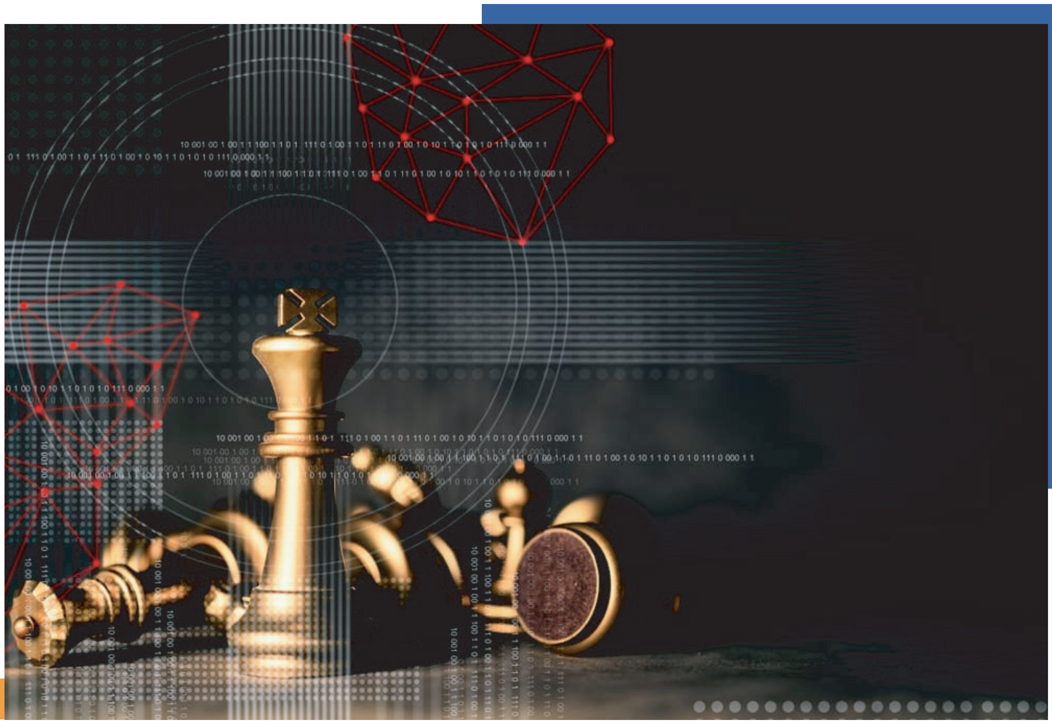
WHAT TYPES OF TACTICAL STRATEGIES ARE THERE?

Most tactical managers are systematic in their approach and their portfolio's performance is a reflection of that system. However, the broader investment mandate and portfolio construction which guides the manager and the manager's system, is more often than not a key driver behind the portfolio's risk/return profile.

Here are three broad categories of tactical strategies as defined by their portfolio construction:

01 STRATEGIC ACTIVE

What is it? Strategic active strategies remain invested entirely in one asset class such as equities. There is no consideration for tactically moving to another asset class like bonds or cash. Due to the stricter mandate, the manager attempts to achieve superior risk-adjusted returns by tactically shifting within that asset class - overweighting growth stocks or underweighting small cap stocks for example.



Why would you use it? For advisors, the benefit of using strategic active strategies is a consistent asset allocation. You know the segment of the portfolio allocated to a strategic active manager will be invested entirely in equities or entirely in fixed income. Strategic active strategies generally have a higher correlation to the market when compared to other types of tactical strategies.

02 ACTIVE

What is it? Tactical active strategies do two things. First, the portfolio adjusts to find areas of strength within the market. These changes may overweight the portfolio in a certain style box or sector. Second, the portfolio shifts from equities to cash (or bonds) to reduce risk, whether in a single-step or multi-step process.

Why would you use it? For advisors, the benefit of using tactical active strategies is the potential to outperform your benchmark when fully invested and the potential to change your client's portfolio from risk-on to risk-off, or vice versa, in a short period of time. Because of their broader mandate, tactical active strategies generally have a low correlation to the market.

03 PASSIVE

What is it? Tactical passive strategies do two things. First, the portfolio invests in a single index. Second, the portfolio shifts from that index to cash (or bonds) to reduce risk, whether in a single-step or multi-step process.

Why would you use it? For advisors, the main benefit of using tactical passive strategies is the potential to change your client's portfolio from risk-on to risk-off, or vice versa, in a short period of time. Tactical passive strategies are not expected to outperform their benchmark during bull markets, but they can add value over a full-market cycle by reducing portfolio drawdowns.

HOW DOES IT WORK?

Within these three broad categories, tactical managers use a variety of techniques including, but not limited to, trend following, mean reversion, rotation, counter trend, and seasonality to achieve their portfolio's objective.

TREND FOLLOWING is a method by which managers seek to identify trends in the assets they invest in. Spotting a new sustainable uptrend in an asset class and identifying when that trend ends is vital to the success of trend following systems.

MEAN REVERSION is a technique whereby managers seek to identify assets whose prices have moved well above or below their historical average with the belief that prices will eventually move back to that historical average.

ROTATION is a process in which managers make changes to the portfolio based upon periodically ranking their list of investment choices. The ranking may occur weekly, monthly, bi-monthly, quarterly, etc. and the ranking criteria may be one or more factors such as momentum, volatility, relative strength, etc.

COUNTER TREND is a means by which managers attempt to make small gains by trading against the current price trend. Counter trend managers seek to identify short-term price extremes caused by market inefficiencies or "noise" and position their portfolio to profit on price movements back to more reasonable levels.

SEASONALITY (CALENDAR EFFECTS) is a means by which managers make changes to portfolios based on historical calendar (or seasonality) market trends for certain assets.

WHAT OTHER FACTORS ARE IMPORTANT?

While portfolio construction and management style are critical factors in determining the behavior of your tactical portfolio, there are other factors that impact that behavior as well.

FREQUENCY (daily, weekly, monthly, etc.) refers to how often your portfolio is monitored. A portfolio that is monitored daily may be quicker to react to changes in the market, but may also be subject to higher turnover.

CONCENTRATION refers to the percentage of the portfolio that can be invested into a single asset or asset class. A portfolio that owns one or only a few securities may provide greater growth potential, but also greater potential for loss.

LEVERAGE refers to the portfolio's ability to have market exposure that is greater than 100% by using leveraged ETFs, leveraged mutual funds, options, etc. Leverage may provide greater growth potential, but also greater potential for loss.

CONTACT US

If you would like more information about Optimus Advisory Group, please visit our **website** or contact us at **info@optimusadvisory.com** or (949) 727-4734.

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