THE SCANNER

Leveraging intermittent **market opportunities** tactically

Large investment portfolios, like those of UHNIs and family offices, have nuanced needs that need to be accomplished at various points in time. This makes optimal asset allocation the cornerstone for managing investor portfolios the right way. For a long-term investment horizon, investors create an investment plan that seeks to maximise their returns while taking on an acceptable level of risk. The long-term investment horizon has an asset allocation plan that meets the various investment constraints such as risk, return, time horizons, liquidity, and taxation to name a few. This long-term asset allocation is called a strategic asset allocation plan.

However, in the near to medium term, often there are intermittent opportunities that astute investors could leverage in an attempt to improve the risk-adjusted returns of their portfolios. This translates into short-term asset weight deviations from the strategic asset allocation plan. These short-term adjustments to asset weights are known as Tactical Asset Allocation (TAA), which is done to add value to the overall portfolio by exploiting market circumstances by underweighting near/medium term underperformers and giving higher weight to assets showing near/medium term outperformance. This is where technical analysis can play an integral role.

Technical analysis strives to interpret market sentiment and identify the market direction, critical support, and resistance zones by studying prices and volumes. It uses various tools such as technical indicators, chart patterns, and tracking the positioning of institutional investors and traders. It makes it easier to identify market trends and shifts in investor sentiment. There are three main ways by which technical analysis can help in TAA:

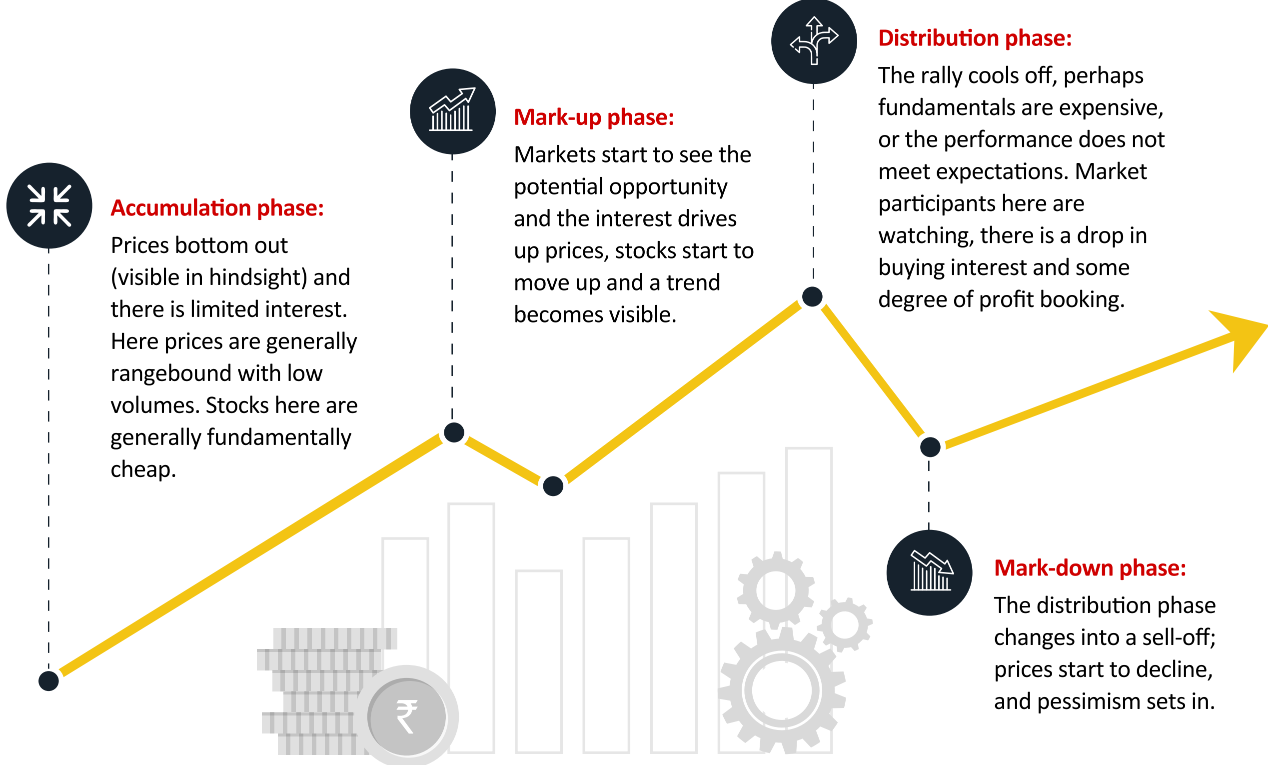
By identifying a near term trend, commenting on its strength, and signalling to the investor to overweight assets in a rising trend or underweight a falling trend.

By finding supports at levels of extreme pessimism, or early signs of a trend reversal, and then combining these levels with fundamental analysis to buy assets with a margin of safety.

By finding resistances at levels of extreme optimism and identifying signs of trend reversal, thus helping the investor exit or reduce exposure to assets that are likely to underperform.

Market phases

Markets are made up of different participants trying to position themselves to gain the highest return on their investments. However, the investment time horizon, risk appetite, and expected returns differ from investor to investor, thereby causing the ebbs and flows of the market. When the majority of participants form a uniform view, prices tend to move in that direction resulting in price trends. Whereas, when the participants' opinions vary too much, there is a lot of buying and selling at a single level, prices tend to be directionless and markets consolidate. The markets can be in one of these two states, i.e., trending or consolidating. We can get a lot of information from where the consolidation happens and the direction of the trend to understand the market sentiment. To do this, we need to understand the 4 key phases of a typical market cycle.



We have used the Nifty Pharma index to illustrate these phases.

In June, our technical desk noted that Nifty Pharma could be in an accumulation phase. Identifying good pharma businesses at attractive prices in time could have helped structure portfolios to gain from the move that came thereafter when the index zoomed from 12,000 to 15,000 – a return of ~25%.

(Nifty Pharma Index as of 23rd Oct 2023)

The Nifty Pharma chart has currently broken out of a consolidation zone - it rested the breakout level and seems to be moving higher. The period between September 2021 to the present date can be viewed as a longer accumulation period from where prices are moving out, thus possibly moving into the next mark-up phase? The pharma space will surely be interesting to watch. Using the concept of phases that we have discussed above, an investor with a position in this space should be mindful that a mark-up is followed by a distribution phase and thus, have an exit strategy in place when the market indicates that a distribution phase is turning into a mark-down phase.

The times when markets consolidate are critical as they may be followed by a mark-up or a mark-down phase. Interpreting whether a consolidation is an accumulation phase or a distribution phase can be a guide to positioning portfolios. An effective way of using technical analysis is to combine the interpretation of the broader technical market with a fundamental view, as when these two align, the momentum in markets can be captured.

Q&A

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Should investors with a long-term outlook consider tactical asset allocation?

Markets are not stagnant as market participants are constantly forming and updating their views on asset valuations. This causes markets to oscillate between extremes of pessimism and optimism. An investor using TAA is able to exploit these market extremes and generate higher returns, whereas an only strategic asset allocation approach is structured to generate returns without leveraging opportunities that emerge from near-term market fluctuations. Therefore, it is advisable that an investor with a long-term outlook consider TAA as well.

Is tactical asset allocation the same thing as trading?

Trading differs from investing in that a trader is only interested in buying low and selling higher, as quickly as possible. A trader would not pay heed to long-term asset allocations and investment goals, but try to identify where a trend is taking shape and capture the highest return in the shortest time, and move to the next opportunity. TAA, on the other hand, takes into consideration the overall investment plan and investor needs and adjusts asset allocations by combining fundamental factors with market behaviour.

What proportion of the portfolio should be tactical in nature?

There are a host of factors that need to be considered when deciding how much of a portfolio should be tactical. TAA involves a higher degree of transactional costs such as brokerage, stamp duties, capital gain taxes. Additionally, when overweighting an asset, it may increase the overall risk due to concentration. Thus, risk reward needs to be considered. The liquidity needs of the investor are another important consideration - can the assets be liquidated quickly with limited loss of capital, what is the expected time that the theme would take to play out? Are there restrictions in terms of the investor-specific circumstances?

Investors should try to answer these questions to understand their specific portfolio allocation needs, however, broadly speaking, a smaller portion of the portfolio should be tactical in nature. This is because strategic asset allocation is more attuned to meeting the investor's investment goals, whereas TAA only aims to capture near term opportunities to add value.

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