

## Efficient Risk Management and Portfolio Flexibility in Global Tactical Asset Allocation

In a previous research note we addressed the impact of portfolio constraints on actively managed portfolios. We argued that hard position constraints such as no net shorting, reduce portfolio efficiency, impede alpha generation, have unintended negative consequences and can lead to portfolio biases. The purpose of this research note is to take a more in depth look at risk management issues by focusing on Global Tactical Asset Allocation (GTAA) strategies.

### CONSTRAINTS & PORTFOLIO EFFICIENCY

In developing policy related to GTAA accounts, investors are often tempted to apply similar position constraints to those applied to managers who specialize in security selection. Out of concern for currency risk for example, managers may be allowed to hedge foreign exposures back to the domestic currency, but not allowed to "hedge" out of domestic currency positions when the manager believes the domestic currency is overvalued. Net short positions in stocks and bonds may also be prohibited. For example, if a country equity market represents 1% of the benchmark weight, the manager is allowed to, at most, underweight that country equity market by a 1%, i.e., have zero exposure in a fully funded account.

While these types of restrictions appear to be somewhat innocuous at first glance, they can have perverse consequences. Not only do they reduce the manager's ability to add value, they can also reduce the investment strategy's efficiency and lead to biases in the portfolio weights. This is not to say that risk control is not important but rather that using the wrong risk control tools can significantly reduce performance and in some cases actually increase total portfolio risk.

### LONG ONLY VERSUS LONG-SHORT

The constraint we initially wish to examine in this context is the no short-selling constraint. To do so it will be helpful to talk about active portfolio weights as opposed to portfolio weights. A manager's portfolio weights are the proportions of the portfolio held in each asset in the portfolio. Portfolio weights sum to one. On the other hand, active portfolio weights are the difference between the portfolio weight and the benchmark weight of each asset in the portfolio. Active portfolio weights sum to zero.

For questions, please contact one of the following co-authors: Charles J. Jacklin, Ph.D. or Edmund Bellord at 415-546-6056