LEGAL UPDATE

Tactical asset allocation under ERISA

By Marsha S. Wagner, Esq. and Dennis Blair, Esq.

Modern portfolio theory

OL has embraced modern portfolio theory in its regulation on prudent investment under ERISA and in other guidance. Some investment managers in anticipation of the stock market collapse in 2008 changed their asset allocation to 100% Treasury securities. The 100% Treasuries position, even if temporary, seems too extreme to be considered a tactical asset allocation ("TAA") that might be compatible with modern portfolio theory.

TAA vs. market timing

Although TAA has been employed at least since 1988,² its popularity seems to increase when the stock market is volatile.³ Although the DOL may ultimately embrace "scientific" market timing⁴ by institutional money managers, it seems clear that the DOL currently disfavors market timing by plan participants:

Among inferior strategies, it is likely that active trading aimed at timing the market generates more adverse results than failing to rebalance. . . . Good advice is likely to discourage market timing efforts and encourage rebalancing, thereby ameliorating adverse impacts from poor trading strategies.⁵

These DOL views on market timing drew comments from the National Association of Active Investment Managers ("NAAIM"):

Several decades ago perhaps, 'market timing' might have had a widely accepted specific definition; probably referring to those who used only technical signals to move between being either 100% in stocks or 100% in cash.... [T]he professional practice of active investment management has also moved well beyond what was originally encompassed by that term. First of all many active investment managers do not use a 100%-in, 100%-out strategy, but rather overweight or underweight an asset class within a maximum-to-minimum range. For example, let's say a manager's neutral allocation to U.S. stocks was 50%. If his or her outlook for the stock market became very unfavorable they might pare clients' stock positions to a minimum 25%; if that outlook markedly improved, they might increase the equity portion to a maximum 75%.6

TAA boundary

As we read the literature, modern portfolio theory should be used to develop the strategic (or static) asset allocation.

TAA would then underweight or overweight the asset classes using a model that detects signals predicting significant deviations from the usual performance relationship of the asset classes.

If TAA adjustments are confined within a 25% corridor around the base line allocation, then the adjustments would appear to be consistent with modern portfolio theory, according to NAAIM's comments to the DOL. However, a fully "defensive" asset allocation out of stocks would appear to be at least questionable under modern portfolio theory.⁷

Large plan sponsors

In keeping with its tradition of publishing white papers on thomy investment issues, Vanguard published a TAA primer two years ago. The audience of the Vanguard TAA primer is institutional investors (e.g., large plan sponsors) and suggests how these investors should evaluate the answer to the following TAA questions:

- What are the critical components of a good TAA model?
- Have most TAA managers produced significant excess returns?
- How long has the TAA strategy in question been operated?
 Does it have at least a three-year track record?
- How have all the TAA manager's strategies performed, not just the ones being touted?
- Who is performing the work? How long has the team been in place?
- What is the manager's approach to TAA investments? Is it easily understood?

Small plan sponsors

Most small plan sponsors will be incapable of asking these questions, let alone evaluating the answers. Without an investment consultant representing plan sponsors' interests, an investment manager would be saddled with the burden of presenting enough understandable information to enable plan sponsors to make a prudent decision to adopt a TAA model. Of course, if the investment manager TAA adjustment causes the asset allocation to outperform the applicable benchmarks, it need not worry about a plan sponsor that does not understand its TAA model. On the other hand, if a TAA adjusted asset allocation lags significantly behind the benchmark, the plan sponsor and investment manger could be exposed to a class action lawsuit by disgruntled plan participants. They would argue that the

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plan sponsor imprudently adopted the TAA model without understanding the science behind it. ❖

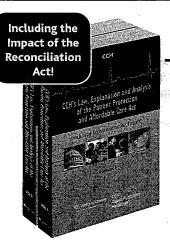
Notes

- 1. 29 C.F.R. § 2550.404a-1. DiFelice v. U.S. Airways, Inc., 497 F.3d 410, 423 (4th Cir. 2007) ("[T]he [trial] court correctly recognized, DiFelice, 436 F. Supp. 2d at 789, that modern portfolio theory has been adopted in the investment community and, for the purposes of ERISA, by the Department of Labor.") Preamble to Interpretive Bulletin 96-1, 61 F.R. 29586, 29587 (June 11, 1996) ("to assure that, for purposes of the [investment education] safe harbors, any models or materials presented to participants or beneficiaries will be consistent with widely accepted principles of modern portfolio theory, recognizing the relationship between risk and return, the historic returns of different asset classes, and the importance of diversification.").
- Gary Belsky, "Top-Rated Jersey Bank Scores with Blue Chips," Crain's New York Business, September 19, 1988, Pg. 2. ("The other big winner locally was giant... Citicorp Investment Management.... Some of its success... resulted from its tactical asset allocation strategy.")
- 3. Leslie P. Norton, "Strategic Revival: Thriving On Market Volatility, Tactical Asset Allocation

- Rides Again," Barron's, May 6, 1996, Pg. 51 ("A near-casualty of the great bull market of the 1990s was tactical asset allocation, an investment strategy that became the vogue directly after the 1987 stock market crash. But having been cast to the sidelines for a time, the approach is experiencing a modest revival.").
- 4. Kaja Whitehouse, "Scientific Market Timing' Is Gaining Credence," Wall Street Journal, September 25, 2003, Pg. D2 ("If you hire someone to manage your investments for you, learn this term: tactical asset allocation. It is an investment strategy that is gaining greater attention by major banks and brokerage houses, and therefore, it is seeing increased use by investors.").
- Preamble to proposed DOL regulations on participant investment advice at 73 Federal Register 49895, 49904 (August 22, 2008). The proposal is posted at http://www.dol.gov/ federalregister/HtmlDisplay.aspx?DocId= 21243&AgencyId=8&DocumentType=1.
- The October 6, 2008, comments by National Association of Active Investment Managers are posted at http://www.dol.gov/ebsa/pdf/ cmt-10070803.pdf.
- 7. "Comptroller's Handbook," Comptroller of the Currency, Administrator of National Banks, Asset Management-Investment Management Services, August 2001, Pg. 111 ("TAA assumes that the client's objectives and risk tolerance stay constant, but that the market environment changes and inefficiencies exist. To control TAA, the investment policy's asset allocation

- guidelines should incorporate prudent ranges of permissible reallocations."). The Comptroller's Handbook is posted at http://www.occ. treas.gov/handbook/invmgt.pdf.
- "A Primer on Tactical Asset Allocation Strategy Evaluation," Vanguard Investment Counseling & Research (2006). The Vanguard primer is posted at http://www.vanguard.com/ pdf/flgtaa.pdf?2210022019.
- 9. The Vanguard primer implies that most plan sponsors would need an investment consultant to help than evaluate a TAA model. According to the Vanguard primer, a plan sponsor would need to understand challenging scientific concepts, such as Bayesian probability calculations ("A [TAA] good model will have a method for ensuring that the selection and testing process is economically reasonable."), the t-statistic ("the arithmetic average return divided by the standard error of the arithmetic average"), historical information ratio ("the ratio of alpha to tracking error, that is, the standard deviation of alpha"), and others.
- 10. Indeed, many plan sponsors are likely to base their evaluation simply on the TAA manager's past performance, despite any disclaimer that past performance does not guarantee future results.

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