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GAINING THE BENEFITS OF GLOBAL TACTICAL ASSET ALLOCATION IN A HOSTILE ENVIRONMENT

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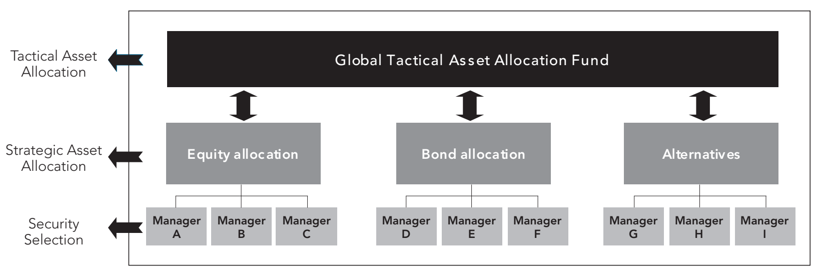
On March 31 and April 1, 2009, Emiel van den Heiligenberg, Chief Investment Officer, Asset Allocation & Balanced Solutions with Fortis Investments, spoke at seminars in Montreal and Toronto on the benefits of global tactical asset allocation.

Global tactical asset allocation (GTAA) is an investment approach that seeks to exploit short-term market inefficiencies to generate uncorrelated absolute returns by taking positions in various asset classes, regions, styles and currencies. Due to its low correlation with traditional asset classes, GTAA can diversify an existing portfolio without making material changes to the portfolio's overall risk characteristics.

THE CONCEPT OF GLOBAL TACTICAL ASSET ALLOCATION

GTAA uses a far wider scope of opportunities than traditional asset allocation, taking long/short positions in liquid exchange-traded futures and foreign exchange forward contracts. As a result, the alpha from GTAA is completely portable and can be overlaid on top of an existing portfolio:



As an overlay, the GTAA portfolio does not interfere with the underlying portfolio. This provides a number of strong benefits:

- GTAA allows for tactical shifts in the effective asset class exposures of the total portfolio without causing large capital movements. This limits any market impact of the tactical moves and also reduces transaction costs.

- GTAA enables a true separation between the asset allocation decision and the security selection decision.

- GTAA requires only a limited cash allocation to affect significant exposures for the portfolio.

- GTAA is completely scalable to the client's risk tolerance.

In addition, because GTAA utilizes liquid exchange-traded futures and similar instruments, it permits a further reduction in transaction costs compared to buying and selling securities in the physical or cash markets.

COMPARISON WITH TRADITIONAL ASSET ALLOCATION

In the past, balanced mandates would practice traditional tactical asset allocation in an attempt to add value through market timing, a practice that has been shown to be generally unsuccessful.

GTAA overcomes the weakness of traditional asset allocation in the following ways:

- By greatly expanding the investment universe:
  Under Grinold and Kahn's famous "fundamental law of active management," the potential information ratio for an investment approach increases when the number of possible independent decisions involved is increased. Where the traditional approach may require allocation decisions across a few simple asset classes (equities, bonds, cash) and regions (Canada, the United States, EAFE), GTAA vastly increases the number of possible allocation decisions, as shown in the example below:

Opportunity Set	Traditional TAA	GTAA
Asset classes	5	5
Equity Regions	4	4
Equity Countries	-	20
Bonds	-	8
Currencies	-	15
Commodities	-	10
Equity sectors	-	15
Total	**9**	**77**

In this example, Grinold and Kahn's law would suggest the potential information ratio for the GTAA manager would be about three times that of the traditional balanced manager simply from this source alone.

- By reducing trading costs:
  Futures contracts are 1,000 times the size of an average stock, while the commission on trading liquid futures is less than 10 percent of the equity trading commission. Furthermore, the bid/ask spread is lower on futures, and so is the market impact of the trades. This means that the total cost of trading in liquid futures is generally about 25 percent of the cost of equivalent trading in the physical markets.

- By using a focused, non-consensus approach:
  Traditional asset allocation is often performed by a committee with representatives of the various asset class teams. Decisions are based on consensus and compromise, and rarely reflect a strong alpha focus. In GTAA, by contrast, the manager usually is fully dedicated and focused on the research and decision making process necessary to run a GTAA portfolio. While most dedicated GTAA managers do use the research of other asset classes, they do so only for idea generation and to challenge their own views, rather than allowing (say) the Japanese equity manager to influence the tactical view on the Japanese equity market. Most successful GTAA managers use multiple independent sources of return, either via independent teams, independent quantitative models or independent risk takers or trade owners. There is little compromise toward a consensus approach or interference from the other teams. The overall portfolio is built by assigning risk sub-budgets to each specialist group in a systematic manner, depending on their investment skills and the de-correlation of the different alpha generators.

BENEFITING FROM MARKET INEFFICIENCIES

GTAA differs from many traditional investment approaches in that it seeks to derive outperformance from macro or top-down decisions. GTAA managers are not looking for inefficiencies between individual securities within a given market, but rather inefficiencies between whole markets or regions.

Most academic studies of market efficiency focus on the internal dynamics of a single, integrated market. These studies often conclude that large liquid markets, such as U.S. equities or bonds, are relatively internally efficient. As a result, in such markets it can be difficult for active security selection to produce sustainable risk-adjusted outperformance.

By contrast, many studies have shown that relatively easily observed variables have the ability to predict broad market returns and market anomalies (like momentum or seasonality of returns) are significant and persistent. In other words, inefficiencies do exist in the macro or cross-market environment. Thus, perhaps counter-intuitively, asset classes are often more inefficiently priced than the individual equities and bonds within them.

Where do these inefficiencies come from? In fact, there are systematic losers in the asset allocation markets. At the institutional level, committee structures and consensus approaches lead to misallocations at times. In addition, some institutional investors are forced sellers in bear markets (and forced buyers in bull markets) due to their solvency requirements. At the retail level, investors tend to drive their decisions while looking in the rear-view mirror, i.e., buying the funds that have done well in the past.

These factors create opportunities for the GTAA manager as he or she is active in a market with attractive alpha potential. This is confirmed by our internal data. Based on our own internal competitor data, the five-year median information ratio for GTAA is substantially positive.

Furthermore, GTAA portfolios should not have intrinsic directional market risk, so one would expect their returns to be quite uncorrelated from market returns. This is borne out by the study summarized in the table on page 20, showing the correlation of the Fortis Investments GTAA composite with various standard market indices.

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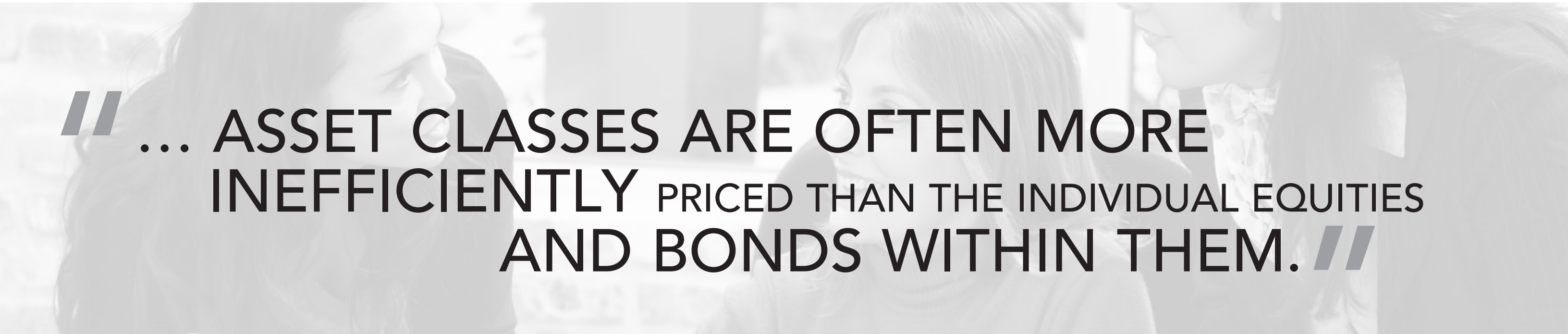
	GTAA	MSCI World	Citigroup EMU GBI All Maturities	Citigroup WGBI All Maturities	GPR 250	S&P 500	DK Euro STOXX 50	Credit Suisse Tremont Hedge Fund
GTTA	1.00							
MSCI World	0.09	1.00						
Citigroup EMU GBI All Maturities	-0.05	-0.29	1.00					
Citigroup WGBI All Maturities	0.06	-0.28	0.53	1.00				
GPR 250	0.04	0.52	0.16	0.03	1.00			
S&P 500	0.07	0.97	-0.32	-0.23	0.43	1.00		
DJ EURO STOXX 50	0.08	0.87	-0.41	-0.10	0.25	0.88	1.00	
Credit Suisse Tremont Hedge Fund	-0.09	0.05	-0.03	0.01	0.15	-0.02	-0.05	1.00

Source: Fortis Investments and Bloomberg
Correlations between different assest classes July 2002 - December 2008
Monthly, all indices in local currencies (unhedged). GTTA Returns are the returns of the Fortis Investments GTAA composite.

The very low correlation of GTAA returns with traditional asset classes suggests that GTAA would be a diversifier when added to a balanced portfolio, reducing risk and/or increasing returns. We examined what would have happened if GTAA had been added to a typical Canadian pension fund portfolio for the three years ending Dec. 31, 2008, and found that adding GTAA would indeed have both reduced risk and increased returns, even with a relatively modest risk budget allocation to GTAA (compare the white and black diamonds):

Please note that the above-mentioned correlations are all based on longer-term data. This is no guarantee that GTAA managers will deliver positive returns. It did transpire that last year's realized information ratio of the GTAA universe, based on internal data, was in fact slightly above zero. Investors that specifically desire some degree of crisis protection should be sure to look in their due diligence for a diversified approach,



" … ASSET CLASSES ARE OFTEN MORE INEFFICIENTLY PRICED THAN THE INDIVIDUAL EQUITIES AND BONDS WITHIN THEM. "

with multiple independent risk sources. Past performance track records from crisis periods may be less useful, as there are not enough data points to draw proper conclusions.

TYPES OF GTAA MANAGEMENT

There are substantial differences between GTAA managers and thus also substantial dispersion in their performance. Specifically, there are two main approaches to managing GTAA overlays: model-driven and judgmental.

The model-driven approach, as the name implies, relies on quantitative models to discern opportunities. This approach has the benefit that it removes the human factor in uncertain markets.

On the other hand, the judgmental approach is able to identify and even anticipate changes earlier than the model-driven approach, and can incorporate variables that cannot be modeled. In the judgmental approach, professional asset managers combine various types of research with their own judgment to assess the relative attractiveness of asset classes and to devise an appropriate strategy to benefit.

Blended GTAA managers combine model-driven and judgmental approaches, thus potentially building in the benefits of both approaches, possibly even with low or negative correlation to each other, and in this way improving the risk-adjusted return.

In addition, GTAA managers also differ in the universe of strategies and methods they use. Some managers might concentrate on just a part of the universe (e.g., currency overlay management). Others might include intra-asset class strategies (e.g., equity long/short strategies). Some may use many small bets, while others may concentrate on a few macro bets. Some may use only one model, while others may use several.

In our view, investors should look for managers using multiple alpha sources and a diversified investment approach in order to get the maximum potential benefit from GTAA. As indicated before, the fundamental law of active management means that it requires less skill to add alpha if one has the opportunity to take many small bets than when one can only take a few large bets.

ACCESSING GTAA MANAGEMENT

A GTAA strategy can be implemented via a pure segregated overlay account or by investing in a GTAA pooled fund.

The segregated overlay structure has the advantage of full flexibility to be customized to the client's requirements, as well as the fact that little cash is needed, but it also requires significantly more involvement and oversight from the client. The client's custodian has to be familiar with collateral management and derivative administration, and has to be able to accommodate a high frequency of trades at reasonable cost to the client. In addition, the client itself will have to enter into ISDAs with a number of counterparties, as the GTAA manager will be trading explicitly on the client's behalf.

The GTAA fund approach is less customized, although it is still completely scalable to the client's risk preference. It requires that actual cash be invested in the GTAA fund, and this involves taking the cash from some other asset class which could affect the overall strategic beta allocation of the client's portfolio. However, this can easily be solved using standard portable alpha techniques to replicate the missing portion of the asset class the cash came from. Other than this, investing in a GTAA fund requires no more ongoing involvement of the client than investing in any other pooled fund. As a result, most GTAA investors invest in a GTAA fund rather than using a segregated overlay.

CONCLUSION

GTAA seeks to generate uncorrelated alpha by exploiting short-term inefficiencies in the global investment markets, taking positions in various asset classes, regions, styles and currencies. There is solid evidence that alpha can indeed be generated in this way. It is portable and scalable, and overcomes the shortcomings of traditional asset allocation by greatly expand-

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ing the investment universe, by decreasing trading costs and by using a focused non-consensus approach.

Thus, adding GTAA can potentially reduce risk and/or increase returns in a diversified portfolio such as a pension or endowment fund. This should especially be the case for GTAA managers using a diversified process and multiple alpha sources.

GTAA can be readily accessed in pooled fund form, or through a segregated overlay, making it available to a wide range of institutional investors. Given the benefits it can provide and the ease with which it can be utilized, GTAA is an interesting proposition for many portfolios.

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