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Preparing your Clients to Take Advantage of Tactical Growth Strategies

All asset classes will periodically endure times of failure or significant decline. If these failures can be identified early on and at least partially avoided, then why stay invested in the failing asset class? This is one of the major shortcomings of any manager with a fixed, strategic investment mandate. A great example of this is mutual funds; most mutual funds, by prospectus, must keep a certain percentage invested (often 85% or higher). We refer to this as "prospectus lock" because even if they want to, these managers cannot sell during times of failure. *How does this help your clients?* It doesn't. When you need the manager the most, they are forced to endure the potential large loss. Tactical managers take the exact opposite approach: participate in bull markets similarly to strategic managers *but* seek to raise cash or move to other asset classes that have better opportunities when markets start to fail. In other words, manage your client's money with equal vigor during both bull markets *and* bear markets. Most clients thought mutual funds did this already. Now you know our purpose.

We have now enjoyed over six years of a bull market in U.S. equities since the lows of March 2009, which is now the third longest in history. As you can see in the chart below, there are three basic types of market declines that are simply distinguished by the size of the decline: A pullback is defined as a 5-10% drop, a correction is a 10-20% decline and a bear market endures a 20+% decline.

S&P 500® Index Price Declines (Excluding Dividends): 1946-2014

Type of Decline	Percent Decline	Count	Average Change	Duration in Months
Pullbacks	5-10%	105	-7%	>1
Corrections	10-20%	19	-14%	5
All Bear Markets	20+%	12	-28%	14
Uncomfortable Bears	20-40%	9	-26%	11
Hellacious Bears	40+%	3	-51%	23

Source: LPL Financial Research, Bloomberg, Capital IQ, Standard and Poor's

Pullbacks are a common occurrence in the equity markets. During the cyclical bull markets since World War II, there have been 105 pullbacks- 13 during the 1990s bull, 12 during the 2002-2007 bull and 19 during the current bull market. On average, there have been three to four pullbacks each year during a bull market and the current 2009-2015 period is no exception.

Why the interest in pullbacks? We believe that no tactical strategy would be able to successfully avoid ordinary 5-10% pullbacks and provide timely reinvestment without being subject to whipsaw. Whipsaw occurs when the price of a security heads in one direction, but is quickly followed by a movement in the opposite direction. The term's origin is from the push and pull action used by two lumberjacks to saw wood with a large, two-handled saw.

As the chart on the following page illustrates, if you think about it further, the first 5% decline simply alerts the manager that the market is in a pullback. Then, before the pullback reaches the bottom, let's say at 10%, the strategy only has the next 1-5% of additional decline to react (sell) if the strategy is to "avoid" any of the pullback. If a manager successfully gets out of the market before the bottom, he then has less than 1-5% of the initial recovery to reinvest without incurring a loss. This example is the best case scenario within a pullback too, because as you can see in the table on the previous page, the average pullback since 1946 was 7%. This means that the manager would only have 2% to react on the downside, and 1% or less to reinvest on the upside.

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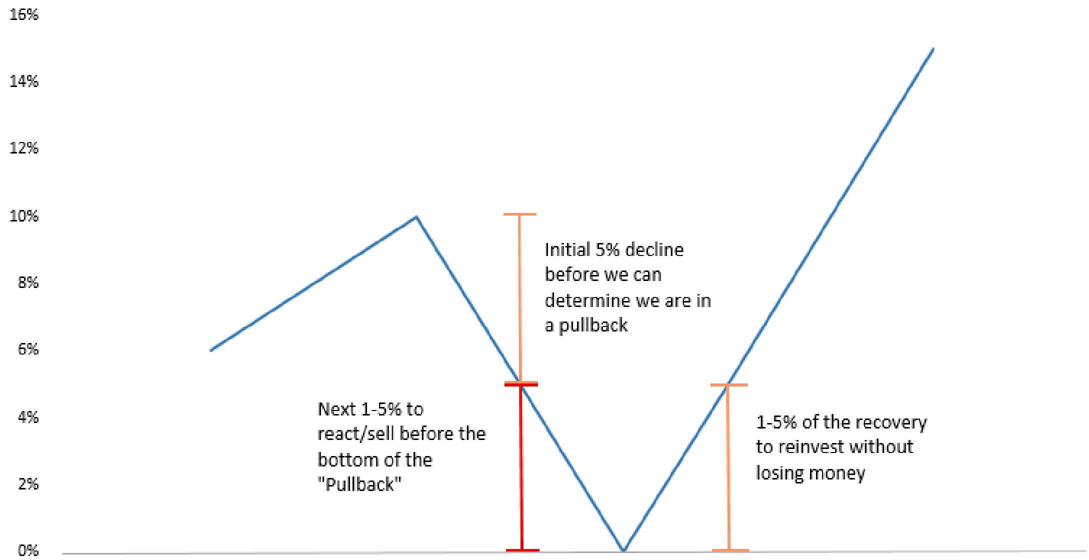
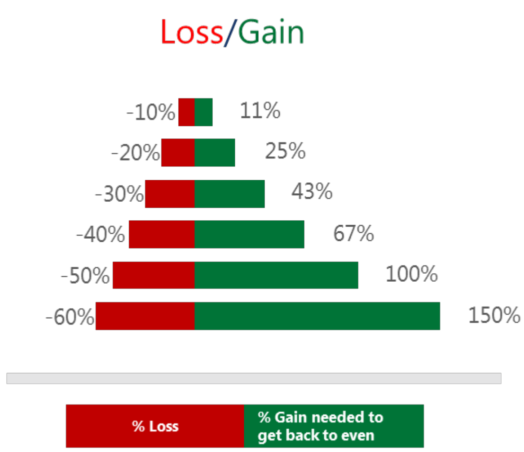


Furthermore, one must consider the element of time. Most pullbacks have lasted just a week or two, often merely a few days. Similarly, the snap-back recovery from the pullback was often achieved just as quickly. We think it is unrealistic that any strategy would be able to correctly sell and buy in such narrow windows, and attempting to achieve this increases the likelihood of whipsaw. If you apply this scenario to a strategy that employs margin, leverage or shorting, it only exacerbates the situation and can make the reaction windows even smaller.

Since pullbacks occur with frequency and consistency, tactical strategies that avoid reacting to pullbacks can be at a distinct advantage. In fact, not reacting to common pullbacks in bull markets has proven to be the better course of action from a performance, turnover and expense standpoint since 1946. It is not the ordinary pullbacks that devastate a portfolio; it is the large losses that induce investors to sell in the capitulation stage of a bear market. This, in turn, can significantly affect their long-term results. As the chart below demonstrates, mathematical reality dictates that the larger the loss, the harder the remaining portfolio capital has to work *just to break even*.



The goal of tactical strategies, therefore, should not to be avoid *all* losses but rather the large losses found in market corrections and bear markets. Understanding this key difference and reviewing these concepts with clients can help set proper client expectations, help them appreciate the benefits of tactical managers and help you create portfolios that can endure the test of time during all market conditions. At Beaumont Capital Management (BCM), we firmly believe the keys to a successful long-term investment strategy are to avoid large losses, take advantage of market opportunities when they present themselves and provide a smoother ride for investors. Each of the BCM Tactical strategies is built on this foundation.

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