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Time was, everyone thought the best asset mix came from Modern Portfolio Theory, which spreads your holdings among as many different, seeming uncorrelated, asset classes as possible. But that didn't work during the 2000-2002 and 2008 downturns. So now, many question the viability of MPT. Fortunately, there's a better way to allocate your assets.

The new approach is called Core & Satellite, or CS. Since most active managers don't beat their benchmark index, the bulk of a CS portfolio – the core part – is in index funds or exchange-traded funds that track global or U.S. stocks. This keeps investment fees and taxes low. A smaller amount is placed in one or more satellites, usually actively managed investments designed to take advantage of opportunities and guard against losses.

A MPT portfolio has a fixed allocation of asset classes, regardless of market direction. The satellite portfolio of a CS portfolio allows it to better respond to changing market conditions.

Of course, this approach is still far from perfect. (What in investing is perfect?) Its holdings tend to be static and aren't shifted often enough to take advantage of market trends. While CS can have better downside protection (depending on how well satellites are managed) than MPT, it is still subject to large losses due to the passive nature of the core. Although CS is better than MPT, it's not by much.

But if we apply a technique called Tactical Asset Allocation (TAA) to Core & Satellite, then the picture is brighter. In a nutshell, you apply TAA to selecting investments.

A Better Approach

With Tactical Asset Allocation, you change the mix of your assets based on their price performance. You favor asset classes that are in an uptrend, and exit those in a downtrend.

There are two methods of doing this. *Relative strength*, also referred to as momentum, entails buying the strongest investment from a basket of two or more asset classes. For example, you could analyze stocks versus bonds or U.S. stocks versus international stocks. *Counter trend analysis* involves buying into short-term weakness and selling into short-term strength.

Tactical Core

With TAA, the core investments are not passive but dynamic. Their goals are to protect the portfolio from large losses, while still participating in gains. The core could consist of a number of different models that invest tactically in global stock funds or exchange-traded funds. If using a relative strength tactic, the core moves to cash or short-term bonds when the market enters a downtrend and shifts back to fully invested when the market enters an uptrend.

This is not, as it may seem, market timing. Market timing tries to get out at market tops and in at market bottoms, movements based on predictions. TAA only moves when a trend is clear.

You weight the holdings using risk, as measured by standard deviation, the metric that gauges how volatile a security is. For example, one allocation model moves between bonds and the **iShares MSCI EAFE** (EFA [1]), which covers stocks in the industrialized world beyond the U.S. Another model alternates between bonds and the **iShares S&P 500 Index** (IVV [2]), tracking the Standard & Poor's 500, the largest American stocks. The monthly standard deviation for the EFA model is 3.57% and for IVV's is 2.47%. To equalize the risk that each brings to the core, you more heavily weight the IVV model.

Tactical Satellites

Using TAA, satellite investments are diversified from the core investments. TAA helps you measure the time you want to hold them and what assets you employ for security, usually bonds. Satellite models could include precious metals, oil and real estate investment trusts.

Putting it All Together

Below is an example of a simple CS portfolio, without the use of TAA modification:

Core

iShares Russell 1000 (IWB [3]) 60%

iShares Barclays Aggregate Bond (AGG [4]) 20%

Satellites

Caldwell & Orkin Market Opportunity (COAGX [5]) 10%

PIMCO All Asset (PASDX [5]) 10%

The core is made up of a broad-based U.S. stock ETF and a bond ETF. The satellite is made up of two flexible mutual funds. The returns of this portfolio as of June 25 are as follows:

Fund	Allocation	5 yr Avg Annual Return	2008 Return
Caldwell & Orkin	10%	3.39%	-4.66%

PIMCO All Asset	10%	5.30%	-15.93%
Russell 1000	60%	-0.35%	-37.42%
Barclays Aggregate	20%	6.64%	7.56%
Portfolio		**1.99%**	**-23.00%**

The Caldwell & Orkin fund and the Barclays Aggregate had relatively decent years in the 2008 crisis year, but they are not weighted enough to significantly diversify the loss on the core Russell 1000. The portfolio itself lost 23% in 2008 and had an average annual return of almost 2% over the past five years, barely keeping pace with inflation.

But when you include more holdings, using counter trends and risk analysis to weight them, the results are better.

So let's see what happens if we employ TAA to form the core and satellite:

Tactical Core 60%

This includes the S&P 500 (IVV [6]), NASDAQ (RYAOX [6]), MSCI EAFE (EFA [7]), emerging markets (EEM [7]), and dividend stocks (IDV [7] and DVY [8]).

Tactical Fixed Income 20%

This includes models that rotate among a number of different bond sectors: high-yield (HYG [9]), long-term Treasuries (RYADX [10]), corporate bonds (LQD [11]), multi-sector (AGG [12]), emerging market (EMB [13]), Treasury Inflation-Protected Securities (TIP [14]), inverse Treasuries (RYJUX [15]) and includes dividend-paying stocks (IDV and DVY). The models are weighted by risk parity.

Tactical Satellite 20%

This includes six models that are equally weighted. Some are opportunistic while others are defensive. The security baskets are much broader than the core and the fixed-income parts of the portfolio.

The returns of this portfolio as of June 25 are as follows:

Strategy	Allocation	5 yr Avg Annual Return	2008 Return

Tactical Satellite	20%	20.67%	25.15%
Tactical Core	60%	13.66%	5.26%
Tactical Fixed Income	20%	12.55%	16.17%
Portfolio		**14.84%**	**11.42%**

This portfolio substantially outperforms the non-TAA CS portfolio. Not necessarily because it does better in years when the market is up, but because it protects investors when the market is down.

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