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What is Tactical Risk Management? (Video)

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In this video, Grimes & Company CEO Kevin Grimes explains tactical equity investing and how tactical risk management strategies can help investors navigate volatile markets. Using examples from the COVID-19 market decline, the 2008 financial crisis, and the 2023 recovery market, he demonstrates how systematic, rules-based investing may help reduce portfolio drawdowns, manage investor emotions, and provide peace of mind during periods of market volatility. This is part one of a two-part series on tactical investing and risk management. In Part 2, Kevin will discuss how tactically managed stock strategies differ from traditional stock strategies. Until then, you can watch Part 1 below and view the full transcript below the fold:

VIDEO TRANSCRIPTION:

Hello, I'm Kevin Grimes, CEO of Grimes & Company. I'm here today to talk about tactical investing, specifically tactical equity investing. And I'm gonna explain a little bit about what that means and how we think about tactical and then give some examples.

Tactical can mean many different things in different contexts. Generally speaking, tactical refers to an approach in response to a short-term opportunity or risk. When we use the term tactical, we are specifically referring to tactical risk management. Think of it as taking evasive action.

In the simplest terms, it's a systematic strategy to reduce risk in a portfolio in response to adverse market signals like declining trends and higher market volatility. Selling when there are measurable signs of trouble and then adding back when market signals are returned to stability.

We use the term systematic because we have a playbook and our portfolio managers are not relying on hunches, human emotions, feelings or intuition. Instead, they are using computer-based programs and signals to make decisions.

Tactical risk management can be used alongside other risk management techniques to build a portfolio that is completely customized to a specific investor.

I'm going to show you how a tactical risk management system might work. And to do that, we're going to need to establish a proxy system.

For this, I will create a program that we can call the 50 slash 200 system.

This is a proxy for a tactical stock strategy. This is not an actual Grimes strategy, which is a far more nuanced thing. The system is to sell or not include the returns of the index if price falls below both the 50-day moving average and the 200-day moving average of price.

If the price is above either moving average, then we will own, or include, the returns of the underlying index. The effect is to create a conditional exposure to the index based on simple, everyday moving averages.

This is a simple system that could be reproduced by anybody that has a charting or portfolio management software system. Let's see an example of this system in action.

Here we are looking at a period that most of us remember well, the COVID period for markets.

You can see here that at the point where the red arrow signals, the S&P 500, which is the underlying index in this case in which we are applying the tactical program to, the S&P 500 at the red arrow dips below both the 200-day moving average, which is yellow, as well as the 50-day moving average, which is purple.

And the S & P 500 index was added back at the green arrow, which is when the S&P 500 rose above the 50 day moving average. So our simple risk management technique here avoided an extremely deep drop in the markets and actually added back the index at a lower or more advantageous level.

During this scenario, the system did not add much return, but it did make the investor feel much better during a very trying time of life. How many people do you know sold around the bottom and waited perhaps almost a year or more to buy back? Waiting for the vaccine was not a good strategy with the benefit of hindsight.

Markets almost always do not do what you think they're going to do, and the global pandemic period was certainly one of them. Certainly, this investor in this hypothetical scenario would have been very happy to avoid a steep decline in the markets and actually add back the underlying index position at a lower level than it was sold at. We'll call that the best case scenario.

Let's look at another example, another difficult market. One that maybe some of the more experienced people in our field can remember, and this is the global financial crisis between 2007 and 2009.

These tactical signals work really well in down markets. They can provide incredible peace of mind for investors because their portfolios are shielded at the scariest of times when investors are tempted to sell and hide with no plan to reinvest.

Let's look at this particular period.

You can see some early ins and outs with the down red arrows and the green arrows rising indicating when this simple system would have sold and added back the S & P 500. Roughly they're selling and adding back approximately at the same levels, maybe slightly advantageous until the market decline really accelerates in the 2008 timeframe.

And you can see a massive decline avoided by our simple system here during that time period. Any investor here would have been very happy to have sidestepped the difficult market and certainly in hindsight would not have minded some ins and outs that didn't really add a lot to the portfolio as the system was looking to shield the portfolio from potential downdrafts.

However, these strategies have limitations as well. There are periods of time when positions can be exited and added back at actually higher levels, hindering performance. It's just a natural byproduct of any system that is looking to reduce risk in a portfolio.

The way the math works for investing is that over time, higher risk, specifically diversified higher risk strategies are expected to return higher levels. Attempts to reduce risk always over time will reduce the potential return because it's a natural byproduct of risk management. And tactical investing at Grimes & Company is a risk management technique. Let's take a look.

Here we have the recovery market in 2023. This is after interest rates soared and inflation spiked to the highest levels in modern times in 2021 and 2022. So this is the recovery market. And you can see here a lot of down red arrows and up green arrows, a lot of flip-flopping in the market.

Now, a Grimes portfolio management system would not trade this fast. It would not have this many ins and outs. But no system is shielded from the simple fact that when you have a volatile market with very quick V bottoms that is rising over time, you can't avoid a period where potentially you're going to be selling and buying back at higher levels.

Defensive action can have adverse effects in some markets when there are quick V bottoms and recoveries. You can't get one without the other because the future is unknowable. It's a system. In conclusion, no system is perfect.

Anything that reduces risk will also reduce upside potential, especially in better markets. That's just how it works. Tactical risk management systems are intended to step in and help investors avoid the worst parts of market declines, and they are an incredibly effective tool in a prolonged bear market.

Someday there will be a true recession and these programs as part of a diversified portfolio will help investors stay the course by smoothing returns, reducing drawdowns, and providing peace of mind.

Our next video will compare a tactical global stock benchmark to a traditional global stock benchmark as well as to a balanced portfolio of global stocks and bonds. Please reach out to one of our portfolio managers to learn more and please remember to read the disclosures. Investing is risky and a professional wealth advisor can help with planning and investing.

I hope you found this informative. Thank you.

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