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What are Strategic and Tactical Decisions?

When investors discuss "strategic" versus "tactical" decisions, they are normally talking about asset allocation. But in order to explain how "strategic" and "tactical" thinking fit with our investment process and how our equity portfolio managers typically assemble portfolios, let's consider how these terms relate to potential drivers of long-term performance. Within our bottom-up framework, is it possible to attribute "tactical" or "strategic" to certain decisions we make?

For us, stock selection is the strategic focus; our country and sector selection is secondary. In a near-perfect stock selection world, the optimal strategic decision would be to pick the best 50 performing stocks and hold on to them for eternity. Strategic decisions are meant to be permanent and are not expected to be reversed. Tactical decisions, on the other hand, are made with a short-term view and are deemed likely to be reversed in the short run.

But what will drive performance? To wrap our head around "eternity," let's consider this question over a century. I believe that performance is less likely to be driven by the country or industry that the stocks are from and more likely to be driven by the particular conditions *within* the company in question that will determine its performance. How much cash does it generate? Does management need to invest? Do they invest sensibly? Do they care about shareholder returns? What taxes or regulation does the company face? All these factors will play a part. Whether the best returns will come from a machinery manufacturer, fast-food chain, bank or biotech company is really hard to know in advance. But the strongest-performing company is likely to be the one that generates the greatest cash flows over time, and which the market has undervalued.

Shorten the time horizon from "eternity" to a decade, and questions of industry or country selection might now assume some significance. But beware the lure of fast-growing sectors as they will attract competition. A sustainable competitive position is key. If we shorten the time horizon further to roughly three years, the business cycle plays a more prominent role. Interest rates and credit cycles become important. The tailwinds of industry growth are enough to outweigh the erosion of returns by competitive elements. Over an even shorter timeframe—one year or less—changes in investors' expectations of government policy, economic growth, the chatter around the Federal Reserve or just pure price momentum dominate.

We believe that at some point, bad corporate governance and bad company fundamentals will cost shareholders money. In the meantime, do we really have the knowledge to compete with all those Fed watchers, the noise and traders, to correctly and consistently follow market sentiment—that is as fickle as the news cycle is short? It's a bit like selecting your wardrobe—classic jackets will last a lifetime, whereas today's fashion trends are gone in a year. In fashion, a series of seasonal trends does not equal a classic look; in investing, the long term is not just a series of short-term decisions—strategy is not a series of tactical decisions. In fashion, the worst that happens is you have some embarrassing photos to look back on; in investing, you risk losing money.

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"The long term is not just a series of short-term decisions; strategy is not a series of tactical decisions."

Strategic versus Tactical in Stock Selection

STRATEGIC VERSUS TACTICAL DECISIONS

Strategic	*Tactical*
Long term	Short term
Assumes limited knowledge of timing	Assumes strong knowledge of timing
Takes advantage of patience	Takes advantage of momentum

Examples

Strategic	*Tactical*
Focus on sustainable return on invested capital (ROIC)	Portfolio trims
Focus on high moats	Cash
Focus on value	Currency

So, what are strategic stock decisions? Quantitative analysis has identified certain factors in stock selection—some of which are long-lasting and others that decay quickly. When we look at the differences between long-term and short-term factors, they fit quite nicely into our framework. The factors that have the shorter lives include things like price momentum signals and changes in analyst recommendations (i.e., following share price moves and the sentiment and news flow in the market). Factors that tend to persist include things like assessments of valuation, the risk profile of the business, and capital allocation decisions. Other factors, such as growth in earnings, changes in margins and changes in returns on capital, sit somewhere between these two extremes. These profiles explain why Matthews Asia analysts and portfolio managers tend to put a high emphasis on judging the risks surrounding a company, its business model and management. But we don't just calculate metrics—we look at what industry structure and corporate processes drive the human actions that create these metrics. Are the incentives right to create sustainable performance? And we ally this with a sensible assessment of the valuation that the market is giving to a company in light of its long-term prospects for cash flow growth.

There is not just one way to perform this analysis. All of these factors are not immutable metrics but more like malleable clay to form a specific view that varies for each business we research. How likely is its business model to succeed? How incentivised are the managers? How likely will these favorable internal conditions persist? We must weigh disparate elements in a particular way to tailor a strategic decision to a particular business.

What is Passive versus Active?

We are active managers. We make stock selection decisions. And we do not do so in a vacuum. Nor do we see our decisions as being made against a benchmark. The passive industry takes a benchmark as a kind of "neutral" view and concludes that it is hard or impossible to do better than that neutral view and so they don't even try. They charge low fees to generate the neutral position. But benchmarks are not neutral in the sense that they have no bias. Typically, they will be biased toward larger businesses and those that have already seen upward price momentum. Benchmarks will also have industry and country allocation biases based on the size of those industries and countries alone. None of these are "strategic" decisions in our sense. Nor would every investor agree that the way a particular benchmark behaves in terms of return and volatility is necessarily "neutral" for them in any meaningful way. Some investors might be happy to see lower returns for less volatility.

So, for us, it does not seem optimal to base our strategic stock selection decisions on some abstract definition of "neutral," which, for us, must be something different from the benchmark. For us, "neutral" is what we refer to as the "personality" of each portfolio. One strategy may have a neutral personality defined by its volatility, another by the average return on capital of the businesses it holds, yet another by the notion of an absolute level of return it seeks to find, or by the split of returns between the income generated by the portfolio and the growth in that income stream over time. These seem entirely more attuned to how our clients think about their investment objectives and much closer to an intuitive sense of what "neutral" really means. Then we seek to find the businesses that best fit that strategy and alter the balance of the portfolio's neutrality according to where risk and valuation lie.

Our Asset Allocation—By Country and Sector

For us, the strategic dominates. When you look at Matthews Asia equity portfolios, you can see that they differ markedly in terms of country allocations and even in sector allocations. For income-driven portfolios, it is natural that countries whose companies produce less dividend income will have a lower weighting. It is

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likely, too, that countries with less shareholder-friendly corporate governance may have lower weightings across our portfolios than their aggregate market capitalizations suggest. For example, only when Japan started to address balance sheet inefficiencies and shareholder return policies in a meaningful way did our portfolio weightings, to strategies investing in Japan, increase. Market institutions and legal frameworks are worthwhile elements to consider when forming a long-term view about a company's performance; interest rate movements and currency gyrations much less so.

In sectors and industries, it may be "more true" to say that the characteristics of an industry can influence the economics of a business. But it is also an area where one must beware! Just because health care is growing quickly does not mean shareholders will make money. The retail sector may be a great place to find the growing businesses, but to blindly invest into recent retail success stories without knowledge of a company's fundamentals is to engage in thematic investing. And thematic investing can, at its extreme, be extremely dangerous—think "dot.com boom" in the U.S., or sports apparel in China in the lead-up to the 2008 Olympics. Automation and industrial process management might generate value for the consumer, but which businesses will actually make money? In every industry, there are well-managed businesses and badly managed businesses, and there are people out there trying just to make a fast return on investors' willingness to buy themes. We try to steer around this—and as a consequence, our strategic thinking about companies tends to also dominate sector allocation.

It should be clear now why our asset allocation in equity portfolios is largely a byproduct of stock picking. If strategic decisions are largely abstract from the short-run macro conditions, and the divergence between country performance is less than the divergence between stock performance over the long run (which it has been), then why not let strategic views on companies dominate on the relative attractiveness of countries or sectors?

Risks Around Tactical Decisions

This is not to say that macro considerations and tactical decisions are absent from what we do. What I have presented is something of a black-and-white view. There may, in theory, be pure strategic decisions, which are those made for a very long time; there may also be pure price momentum decisions, those purely tactical with no fidelity beyond the present. But these types of decisions are so rare as to be practically non-existent. Each decision is part strategic and part tactical, with the degree of each determined by the types of factors considered in the decision and the weight given to each. There are times when you do have to take advantage of acute price movements in markets. And there are times when you have to assess the likelihood of big macro events. But it is from the point of view of assessing risk, not about trying to make a profit from a correct forecasting of future events that we tend to approach these questions.

We occasionally experience some increased turnover in our portfolios as we trim what appear to be expensive positions and add to positions that are more reasonably priced. Some of this turnover includes adding new ideas—often it is done within the portfolios themselves. Admittedly, there is a tactical element in all of this. However, we would say that we are making an assessment of valuations—one of our strategic factors—and we are not replacing good businesses with bad ones. Often these decisions can be sparked by what we see as aggressive moves in prices, unsupported by the realized fundamental operating performance of the company—or, where the dispersion between the upside and downside risks around the investment decision have widened to a point where it is inappropriate to continue to hold a stock given the portfolio's "personality."

We make tactical decisions sparingly. Beware! Lots of short-term decisions over the long run does not equate to having a long-term investment horizon. In the end, it is by trying to judge our level of conviction in our long-term view and to execute that with the humility to realize that, although we are patient, we are not always going to be correct on the strategic issues. We just think we have better insight in strategic decisions than we do in tactical ones.

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