Why every institutional investor should use a TAA implementation

Insights
July 2025

At State Street Investment Management, we believe global capital markets can be inefficient in the short run — driven by behavioral biases, market frictions, and fluctuations in risk aversion. Incorporating tactical asset allocation (TAA) can be a way to exploit these inefficiencies and provide the potential for an uncorrelated source of excess return, while helping to manage risk.

Generally, the objective of TAA is to outperform the benchmark (strategic asset allocation) by dynamically pulling the levers of asset allocation. Our quantitatively anchored, tactical investment process is refined with qualitative insights from our team of experts and managed in a risk-aware framework.

The opportunity set

Our tactical asset allocation investment process seeks to exploit two related but different categories of investment opportunities — directional and relative value. In the directional category, we evaluate broad asset class comparisons, (i.e., global equities vs core bonds), while in the relative value category we examine intra-asset class opportunities, (i.e., country, region or sector within equities and interest rates versus credit within fixed income). We make this nuanced but important distinction to most effectively utilize our quantitative and discretionary resources.

The tactical investment process begins with an assessment of the current political and policy environment, risk sentiment and macroeconomic conditions. Next, we use our proprietary models to objectively evaluate and make asset class comparisons. This is followed by a qualitative review to identify potential blind spots in the quantitative models.

Figure 1: Categories of tactical asset allocation investment opportunities

Directional	Relative value
Broad asset class opportunities	Inter-asset class opportunities
Equities, Core Bonds, Commodities, Gold, High yield, and Cash	*Equities: Sector, Contry, Region*
	Fixed Income: Interest Rates and Credit

Source: State Street Investment Management, Investment Solutions Group (ISG).

When evaluating the broad asset class or directional opportunities, we think it is critical to be mindful of investor attitudes toward risk. Determining the level of risk appetite present in the markets helps us understand investor attitudes towards risk assets. State Street Global Advisors' Market Regime Indicator (MRI) is a dynamic model that incorporates a variety of indicators such as credit spreads, implied volatility, equity market trends, economic growth indicators, Fed balance sheet among others to evaluate investor risk sentiment and identify investors' risk aversion levels. The underlying signals are geographically diversified within each asset class. Increasing implied volatility and widening credit spreads suggest heightened risk aversion, both of which can be headwinds for growth assets. Ultimately, a combination of our market regime indicator model, macroeconomic, and policy and politics views help shape our outlook on risk aversion in the market.

Our research shows that each market regime can have distinctly different return and drawdown attributes. Low

Figure 2: The Market Regime Indicator

Source: State Street Investment Management, Investment Solutions Group (ISG).
The Market Regime Indicator (MRI) is a quantitative framework that attempts to identify the current market risk environment based on forward-looking market indicators. We believe the factors used, equity implied volatility, currency pairs implied volatility and bond spreads, are good indicators of the current risk environment as they are responsive to real-time market impacts and in theory should include all current and forward views of those markets. The information contained above is for illustrative purposes only.

and moderate-risk aversion regimes are typically the most profitable environment for taking risk. In contrast, elevated and high-risk aversion regime can present headwinds for growth assets that can drive negative returns. The MRI is a key driver of the active positioning for those broad-based, directional opportunities. During elevated and high-risk aversion regimes, we will typically underweight the allocation to equities and favor a risk-hedging basket of US Treasuries, gold and cash. Conversely, during low and moderate-risk aversion regimes, we switch the portfolio allocation in favor of global equities and reduce the exposure to core bonds.

In addition to our market regime indicator model, we employ a quantitative framework to evaluate the relative attractiveness of various assets and form total return forecasts. We use these models to help identify both directional and relative value investment opportunities.

Our proprietary models employ a multi-factor approach to sift through large quantities of data and evaluate the attractiveness of investment opportunities through a fundamental lens. These include both top-down and bottom-up analysis to *forecast predicted returns for over 100 market segments*. Top-down macroeconomic factors include variables such as inflation, GDP growth, and leading economic indicators. Bottom up or Asset class specific factors include earnings and dividend yields, valuations, credit spreads, and momentum.

Conclusion

Tactical asset allocation can be an effective way to exploit asset-class level inefficiencies to generate diversified source of excess return and help to manage risk.

About State Street Investment Management

At State Street Investment Management, we draw from our global scale and market-tested expertise to help create original solutions and better outcomes for our clients and the world's investors.

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