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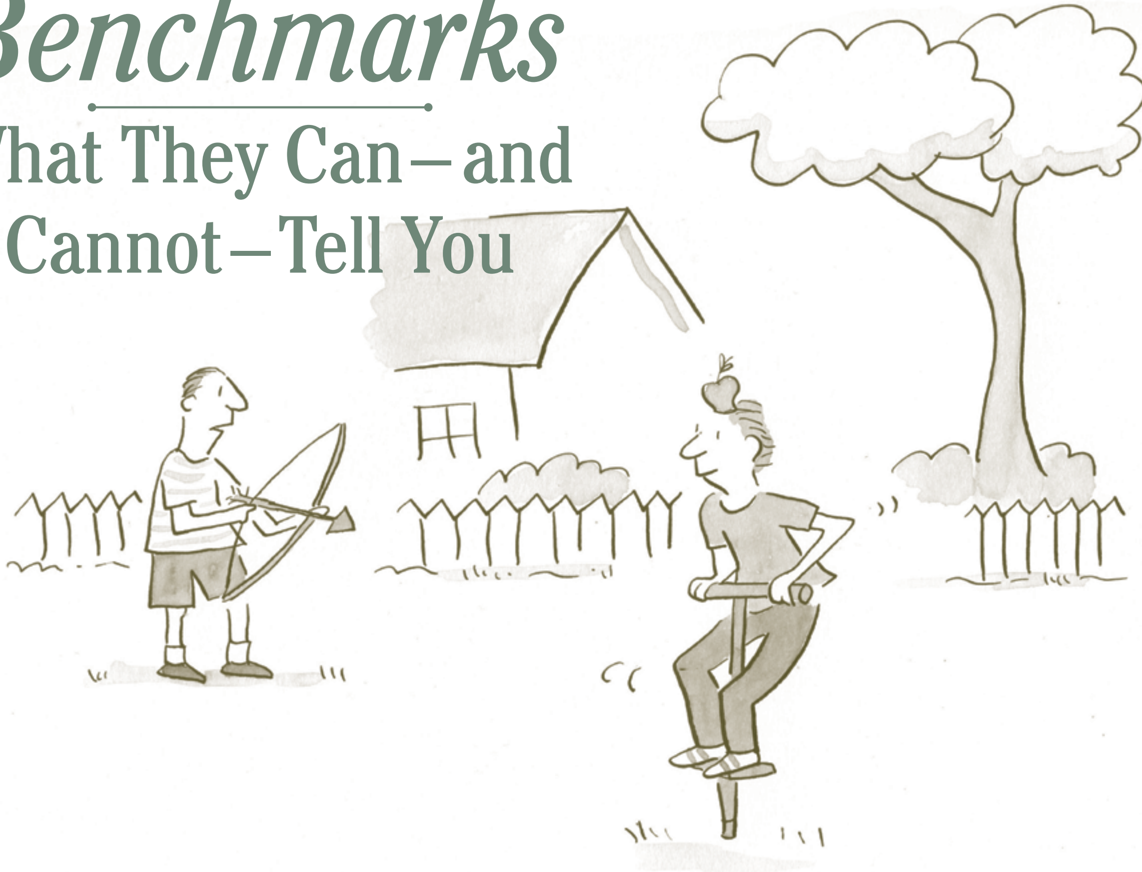
Benchmarks

What They Can—and Cannot—Tell You



Benchmarks are a standard convention in the investment industry, and they can play an important role in measuring the success of investments and investment managers. However, benchmarks frequently complicate matters more than they help. While the industry publishes thousands of standardized benchmarks, none of them provides an "apples-to-apples" comparison to an investor's overall diversified portfolio of stocks, bonds, and alternatives. More importantly, benchmarks can't tell investors whether or not they are meeting their individual investment goals. This article will highlight how benchmarks are established, what they can and cannot measure, and how RMB helps our clients gauge whether their performance is on track. »

Investment managers typically show the performance of an applicable benchmark, or market index, alongside their own performance when displaying investment results to clients. Benchmarks are considered applicable when they are composed of similar types of securities and have similar risk and return characteristics to the investment product with which they are being compared. While this may seem relatively straightforward, there is a lot of room for interpretation. For example, consider two different benchmarks commonly used for large-cap U.S. stocks: the S&P 500 and the Russell 1000. How should one determine which is the more applicable comparison for a large-cap U.S. stock portfolio? They each consist of large-cap, U.S. stocks, and each is constructed based on a predefined set of rules. However, the rules are benchmark-specific, not consistent across benchmarks, so they differ in how "large-cap stock" is defined, how frequently the index composition is reassessed, and how various stocks are weighted within the index. Therefore, these indices cannot provide a definitive answer as to whether an investment strategy is performing appropriately; rather, they should be considered only a general guidepost.

While comparing the performance of an investment strategy to a broad index of similar, relevant securities is an imperfect means of evaluating that strategy's performance, individual benchmarks are a useful tool in constructing total portfolios and measuring the success of individual portfolio components, because we can make projections of risk and return for different market indices over different periods of time. Benchmarks also serve as one indicator of whether the manager has made good investment decisions among the universe of securities from which he or she selects. And the fact that managers know they are being compared to a market index can also help keep them within their investment guidelines. For example, if a manager's mandate is to select large-cap U.S. stocks and his or her portfolio is benchmarked against the S&P 500, it would raise a red flag if the manager put 25% of portfolio holdings in small-cap Chinese companies. Doing so would introduce a new set of risks to the portfolio outside of what was originally conceived, upsetting the risk-reward balance within an investor's total portfolio allocation.

However, benchmarks have the potential to incentivize bad behavior by investment managers, because their performance is frequently measured on a relative basis rather than an absolute basis. So, rather than trying to produce good returns, managers may simply try to produce returns in excess of their benchmark, which can cloud their judgment and create the opposite outcome. For example, managers may take significant risks in their portfolios that they might otherwise avoid simply because those risks are in the benchmark. Alternatively, if performance is trailing and managers believe making a big bet offers the only chance to catch up, they may take significant risks that are not in the benchmark. Furthermore, managing to a benchmark can cause managers to be "closet indexers," meaning they construct portfolios to look and behave very similarly to the benchmark. As a result, they wouldn't ever have great outperformance, but they wouldn't have significant underperformance either. This practice adds more to a manager's job security than it does to his or her clients' investment results.

Perhaps the biggest hazard of an overreliance on benchmarks and relative performance comparisons is that they can lead investors to narrowly focus on individual allocations and lose sight of the broader performance trends in their entire portfolio. The most important question investors should be asking themselves is whether their portfolio has an appropriate level of risk and reward – both of which must be defined on an individual basis. Some investors are very willing to take on whatever risk will enable their portfolio to earn the highest possible return. Other investors will accept the best return they can get within a specific set of parameters, based on the risk they are willing to assume. Investors often have specific needs or wants that they hope will be satisfied by saving and investing over time, such as maintaining their lifestyle in retirement, buying a vacation home, or funding their children's education. In all of these cases, the performance of a broad portfolio relative to standardized benchmarks offers no indication of progress toward achieving individual financial goals. »

At RMB, we work side by side with our clients to translate their goals into a long-term financial plan. We help clients calculate how much they need to save and how much they need to earn on their investments in order to meet their goals, and then we construct a custom-designed portfolio that we believe gives them the best chance of meeting those goals. Clients who require higher returns from their investment portfolios in order to achieve their objectives will typically need to take on more risk in their portfolios to increase the likelihood of meeting their goals. Clients who don't need to rely as much on portfolio returns to satisfy long-term goals may have a more conservatively constructed portfolio, as they already have a higher degree of certainty in their outcome. Once our clients' investment needs have been determined in this way, the success of their portfolio is, first and foremost, benchmarked to their personal objectives.

Of course, we do use standard industry benchmarks to measure performance – to an extent. At an asset class level, we compare the performance of our equity investments to a broad equity benchmark, the performance of our fixed income investments to a broad fixed income benchmark, etc. While we aim for each asset class of investments to beat its benchmark over the long term, we recognize that, in any given period of time, one asset class may lag while another outperforms. Similarly, the underlying investment strategies within an asset class have their own benchmarks, so we monitor those individual strategies carefully, again with the objective that they beat their individual benchmarks over time. When we see that a particular asset class or underlying strategy has underperformed its benchmarks in a given period, it helps us understand the parts of our clients' portfolios that require more attention and potentially can be improved upon. However, the over- or underperformance of individual strategies versus market benchmarks is of tertiary concern, and of entire asset classes is only of secondary concern; our primary concern is whether our clients' entire portfolios are properly constructed in order to meet their individual, personalized investment goals.

Setting personalized investment objectives, and constructing portfolios in the manner most likely to achieve those goals, is one of the most important services our advisors provide to our clients. The multitude of benchmarks the industry publishes can serve as helpful guideposts for measuring particular portions of an investment portfolio, but if investors let standardized industry benchmarks steer their investment decision making, it can hinder their long-term success. ■

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Index Descriptions

- The S&P 500 index is widely regarded as the best single gauge of the U.S. equity market. It includes 500 leading companies in leading industries of the U.S. economy. The S&P 500 focuses on the large-cap segment of the market and covers approximately 75% of U.S. equities.
- The Russell 1000 is an index of approximately 1,000 of the largest companies in the U.S. equity markets; the Russell 1000 is a subset of the Russell 3000 Index. The Russell 1000 comprises more than 90% of the total market capitalization of all listed U.S. stocks and is considered a bellwether index for large-cap investing.