Benchmarks: Beware the Compare

QAM Perspectives – September 2018

Quadrant's regular newsletter that highlights topics we believe will affect markets or are important in understanding them.

"The human brain is built to compare; it's Darwinian to consider an alternative when one presents itself."

Helen Fisher (American anthropologist and human behavior researcher)

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Humans are built to compare and compete – it's a primal instinct. For the greater part of human history we have had to compete and compare for our very survival. For much of the world's population this competition to survive remains, but for many of us our urge to compete and compare is less about survival, per se, and more a function of our innate need to know "how am I doing" versus the pack.

The need to compare results extends to our behaviour as investors. Even if our investment results are positive, we need to know how those results stack up against other investment choices. We want to know that we have "won" at investing and are fearful of the chance of having "lost" in comparison to some alternative.

The investment industry has spent immense efforts to understand and benchmark the dynamics of the capital markets in order to make *informed* comparisons of results and find a better way to compete. That said, two common types of comparisons include:

1. Comparing results to a relevant broad market index.
2. Comparing results to a population of peers.

This newsletter will focus mainly on broad market index benchmarks and will explore in general terms what benchmarks really are, why we use them (even though they are often imperfect), and why it's important to remove the "winning vs. losing" emotions from the equation when comparing performance to a benchmark.

A Brief History of Benchmarks

The term *benchmark* originates from the chiseled horizontal marks that British land surveyors made in stone structures during the 1800s. These benchmarks allowed an angle iron to be fitted into the slot to give a "bench" or support for a levelling staff. Benchmarks were usually indicated with a chiseled arrow directly below the horizontal line and they served as stable reference points to measure the elevation relative to other benchmarks or to sea level.

Over time, the term *benchmark* has become a more general term to describe anything which acts as a point of reference from which comparisons can be made. For example, benchmarks are commonly used in education assessments, testing and comparing the performance of computers, and comparing the performance of various investments.

Benchmarks in Portfolio Management

Investment benchmarks can be useful in portfolio management as they can serve as a reasonable reference point to compare risk characteristics and performance against. Benchmarks offer investors a simple method of monitoring the performance of their investments to determine if it is in line with reasonable expectations or possible alternatives.

Given that there are countless investment options and strategies that investors can implement, there is also a wide range of possible benchmarks. It is important to select a benchmark that makes sense, otherwise any comparison to it could lead to false positives or false negatives in assessing portfolio performance. How do you determine what a proper benchmark is?

The current investment industry practice for assessing if a benchmark is valid follows the SAMURAI acronym:

1. ***S****pecified in advance*. The benchmark is specified at the start of an investment period.
2. ***A****ppropriate*. The benchmark is consistent with the investment portfolio approach and style.
3. ***M****easurable*. The benchmark return can be calculated on a frequent basis.
4. ***U****nambiguous*. The benchmark and its component parts are clearly defined.
5. ***R****eflective of current investment opinions*. The securities within the benchmark are known and relevant to the investor or investment manager.
6. ***A****ccountable*. The investor or investment manager accepts the benchmark and agrees to accept differences in performance between the portfolio and the benchmark.
7. ***I****nvestable*. It is possible to replicate or invest in the benchmark directly.

The SAMURAI criteria seeks to establish the “goodness of fit” of a particular benchmark with the portfolio you are looking to compare to. In order to effectively do this, it is important to understand what a benchmark is composed of and recognize any limitations that it may have. In many cases a benchmark simply represents a hypothetical investment portfolio that has its own risk and return characteristics.

For example, the Standard and Poor’s 500 (S&P 500) Index is one of the world’s most recognized stock market indices. The underlying securities within the S&P 500 Index are chosen by Standard & Poor’s based on several criteria and are weighted based on their market cap (size). The index is designed to be broadly representative of the U.S. large cap investable universe and by most accounts is generally accepted as a reasonable benchmark to compare to a large cap U.S. equity portfolio. However, a crucial fact to note is that the singular objective of the S&P 500 Index is to “measure performance” across the U.S. large cap investment universe. There is no attempt to measure or manage the potential risk within the index – something that is fundamental to portfolio management (more on this below).

It is also important to realize that in some instances there may not be any benchmark that is useful or instructive when making a comparison of portfolio performance. In these cases, investors will need to use discretion and select a fair proxy while understanding any inherent limitations it may have. For example, it is typically more of a challenge to ascribe an appropriate benchmark to illiquid and alternative asset classes.

Ultimately, once a benchmark is chosen it comes down to the simple fact that every comparison is a matter of interpretation.

Beware the Compare

The key to assessing portfolio performance relative to a benchmark is understanding the structural differences in portfolio composition and deciding whether or not you are comfortable with the deviations from a risk/reward perspective over long time periods. For example, a portfolio of U.S. large cap equities concentrated in the technology sector during the late 1990s would have outperformed the S&P 500 Index during that time period, but the level of risk in the portfolio would have been significantly greater (as evidenced by the subsequent tech bubble crash in the early 2000s). A portfolio of U.S. large cap equities with a low weighting to the financial sector relative to the S&P 500 Index during the mid-2000s would have underperformed during that time period, but the level of risk in the portfolio would have been significantly lower (as evidenced by the subsequent financial crisis in 2008).

Continuing with our S&P 500 Index example, the index is currently relatively top-heavy with 6 companies (1.2% of the 500 underlying constituents) representing approximately 17% of the combined index weight. If a comparative portfolio does not hold those 6 companies in similar proportion to the index, the impact (positive or negative) on performance needs to be interpreted when making the comparison. Consideration of the rationale for either holding or not holding those index constituents is part of that interpretation. As mentioned earlier, the S&P 500 Index (and any other broad market index for that matter) does not attempt to manage risk within the portfolio – the only objective is to represent the broad market at any given point in time.

Winning vs. Losing

The theory of loss aversion in psychology refers to the tendency for people to prefer avoiding losses as opposed to acquiring equivalent gains. It is believed that people feel losses twice as strongly as they feel wins (would you rather lose $100 or win $100?). It is no surprise that some investors hate underperforming a benchmark because it is often perceived as "losing".

In reality, benchmark underperformance does not necessarily mean that an investor is losing given the myriad of comparison considerations we have touched upon with respect to benchmarks. This holds true even in the case of a "perfect" benchmark. The simplest example of this is investing in index-based exchange traded funds (ETFs), which by their very design track an underlying index. The ETF will underperform its benchmark 100% of the time due to fees, but it can serve as a simple solution for other goals such as attaining broad exposure to a particular asset class at a reduced cost for the benefit of the portfolio as a whole.

In short, investors should seek to eliminate the "winning vs. losing" emotions when comparing performance to a benchmark as that thought process can distract from a rational and informed analysis of the facts.

Personal Benchmarks Matter the Most

As a private wealth management firm, Quadrant seeks a comprehensive and in depth understanding of our clients and their financial goals and circumstances. In addition to managing investment portfolios, we provide advice and in-depth planning with respect to retirement, estate planning, risk management, taxation, and charitable giving. We believe that all of these important financial matters are intertwined and deserve to be viewed through a holistic wealth planning lens. At the end of the day, the benchmark with the most significance is the personal benchmark – the benchmark that represents whether a client is on track to meet their overall financial goals.

If you or someone you know could benefit from our services, please have them contact our offices at 204-944-8124 or email us at inquiries@quadasset.com.