the tortoise & the hare

MASECO PRIVATE WEALTH

Choosing the appropriate benchmark

Everybody in the investment world, both on the client side as well as the industry, should have an appropriate benchmark. How else would one properly understand the risks the manager is targeting and whether the manager is delivering good performance versus their mandate?

For index trackers like Exchange Traded Funds (ETFs), the goal is to achieve the performance of the benchmark index net of fund cost. On the active management side, everyone targets a performance net of fund cost that is better than benchmark. It is critical to note at the outset that indices never carry any costs but, of course, all managers do, both to earn a living as well as to pay for all the costs of offering an investment strategy. **Therefore, flat relative performance is already a positive, often overlooked, achievement.**

The outcome of any comparison not only depends on the success or failure of the chosen investment strategy but also on the benchmark chosen for comparison. So, the choice of benchmark is absolutely critical. But the big question is, what is the supposedly "right" benchmark for a given investment goal; Is it cash? Or a peer benchmark? Or even a custom combination of various indices? Should it be a global index like MSCI All Country or a local index like the S&P 500 or the FTSE 100? At MASECO we have our own answers to all these questions and I want to summarize here both the answers and the rationale for you.

I will start by sharing our beliefs regarding three basic criteria that any benchmark should aim to satisfy to be labelled a "good" benchmark:

Simplicity - any indices used as benchmarks should be well known and understood by the clients.

Appropriateness - a benchmark should reflect critical investment guidelines agreed with the clients.

Clarity - a benchmark should enable the client to understand the success or failure of the pursued investment strategy and the decisions taken in the process.

For the standard active fund, no matter if bond or equity, the answer seems straight forward: pick an index as a benchmark that represents the investment universe. For example, if a fund only invests in UK stocks, pick a UK equity index. But would such benchmark provide clarity for an investment strategy that aims to always be exposed to value and small cap stocks, particularly if small cap or value index alternatives exist that could have been chosen as the benchmark instead?

This question leads to one of the most important points investors need to remember when thinking about benchmarks and their purpose: **A good benchmark is only a good tool for evaluating the performance of the specific product or portfolio under consideration.** It is not automatically a good tool for comparing different investment managers with the same benchmark. Why? Because what is fair and appropriate is and always will be a subjective decision. More importantly, the investment mandates may differ more than their own naming might lead you to believe.

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If a private client attempts to compare investment managers that seemingly have very similar mandates but use different benchmarks, this should also raise warning signs. For example, two managers might have identical mandates except for the currency perspective. The absolute performance will differ widely because of that one difference and, therefore, their performance track records should under no circumstances be compared when attempting to decide which of the two is a better investment manager. Another example is two mandates that target the same level of risk but the permitted equity investment universe in one case is global and in the other case is local, such as the US equities. Again, comparing these two is like comparing apples and oranges.

In summary, comparing multiple investment strategies to determine a superior manager should always include comparing both their investment mandates as well as their benchmark choices.

Benchmark choices become more complicated for investment strategies that have the freedom to invest in multiple asset classes, like all MASECO's strategies. The biggest conundrum is the fact that multi asset strategies are run at different risk levels, from very conservative to highly aggressive. Let's look at the available alternatives one by one.

A peer benchmark already fails to make the first hurdle. Can you name a peer index and explain how it is constructed? Even industry experts would struggle to name the index components (peers) as often the composition as well as the names of the peers are not easily accessible from the index provider. Also, some indices suffer from survivorship bias, so can't provide a high degree of clarity; Peers can decide when to start and when to stop sending their performance data to the index provider.

Of course, cash indices easily meet the criteria for simplicity. Also, beyond the obvious money market fund, they may be most appropriate for multi asset absolute return strategies, given that the investment objective usually states the aim of producing better returns than cash. But clarity depends on the investment strategies and decisions inside such funds. If a fund is not market neutral, for example, if a long term small exposure to equities exists, it would not be fair to label beating the benchmark a success, as evidence of the equity premium very likely tilts long term performance to be above cash.

Another alternative to benchmark multi asset portfolios is to use an inflation index. The argument for this choice is often the link to the ultimate investment objective of the client, which is to improve their attempt to match liabilities or, in other words, for their assets to grow faster than their costs. This benchmark is also beautifully simple. But I would argue that this benchmark may not be appropriate as it is indifferent to the level of risk taken. So, it has the same pitfall as cash.

MASECO has always benchmarked most client portfolios against composite benchmarks which are a combination of multiple indices with each index assigned a weight so that all add up to 100%. We can certainly argue that our benchmarks have always been appropriate as they captured the long-term asset class exposures we targeted for every level of risk our clients can select. But were they sufficiently simple? And did they provide sufficient clarity so that clients could understand the quality of most of our decision making?

Last Autumn I argued that we should change benchmarks and here is why:

If your benchmarks consist of many components and those components change over time reflecting changes to our long-term asset allocation, that benchmark might not be simple enough for clients to understand, even if we choose well known indices to do so. If the benchmark itself is difficult to understand, it creates poor starting conditions for that client to understand performance comparisons and attribution of the portfolio afterwards.

Clients were able to judge the quality of our fund selection. However, a comparison of their portfolio with its previous benchmark did not help them understand if our selection of return premia and market selection has turned out to have the benefits for which we were aiming.

The benchmarks we introduced at the beginning of the year could hardly be simpler: Every unconstrained portfolio across our firm has a benchmark that is a combination of just cash and equity. Benchmarks only vary to account for the currency perspective and the level of long term risk we agreed with each client. We chose cash instead of any bond index for our benchmark concept to span all risk appetites, even very low risk.

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As the best proxy for equities we chose the MSCI All Country World Index (ACWI), a market leading index with over $4.1tn benchmarked to it[1]. Its broad country representation includes developed and emerging markets and ACWI appropriately reflects our equity investment universe in all our core portfolios.

This benchmark system fits our strategy as, in our portfolio construction, the long-term portfolio risk is targeted using the estimated risk of the benchmark itself. In other words, portfolio and benchmark are linked at the hip. As a nice additional benefit, looking at risk adjusted or total returns provides the same conclusions, again making it easier for clients.

The new benchmarks enable us to be more granular in the attribution analysis we share with our clients on top of what each custodian provides as a performance report. Whilst it requires considerably more work, next year we will introduce an additional attribution report for the first time that attributes performance between market selection, return premia selection and fund selection.

[1] As reported by MSCI on September 30, 2018, based on data by eVestment, Morningstar and Bloomberg as of June 30, 2018

I am excited about this prospect and I can imagine some of you might want to know more now but this development deserves proper and therefore detailed explanation, which is better provided at the same time as the launch of the additional report.

At our 3rd, most recent Research Exchange, where industry experts from academia, consultancy and pension funds participate, I was told that both our approach to portfolio construction and our benchmark system are at the cusp of the latest research into goal-based investing, or what is known as a total portfolio approach on the institutional investment side. You can imagine, at first, I was pleased to hear this industry affirmation. However, having had time to reflect, not surprisingly to those of you who know me well, this feedback is nothing more than a couple of additional opinions that happen to agree with us. Benchmark choices can't ever become fully objective. We have tried our best and will continue to do so but, like you, even though we are specialists in the field of investing, we never stop learning. In that spirit, on the topic of this article as well as past and future ones, please share any questions or feedback with your Wealth Manager.