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Smarter Way to Benchmark

If you're comparing a multi-asset client portfolio to the S&P 500, you're setting yourself up for trouble.

By Craig L. Israelsen

For years there has been a serious disconnect between investors and indexes — which has led to a great deal of bad benchmarking.

Because the S&P 500 is so well publicized, it's not uncommon to see it used as a performance comparison, or benchmark, for any number of investment portfolios. For instance, the S&P 500 is positioned all too often as the performance comparison for a diversified portfolio that contains stocks, bonds and diversifiers (such as real estate and commodities).

Here's the problem: The S&P 500 is not actually similar to a broadly diversified, multi-asset portfolio. (See the "Bad Benchmarking" chart on the following page.) And comparing a multi-asset portfolio against only one of its ingredients is not helpful, valid or even logical. It's just loony.

The primary reason it's done is because of habit — and because it's easy to track the performance of an index that is so well publicized. However, habit and ease are seldom the hallmarks of best practice.

For advisors and investors alike, the real key to understanding and evaluating portfolio performance is selecting a benchmark that is similar to the portfolio being measured against it. But historically, investors have faced a challenge: While virtually all clients benefit from diversified, multi-asset portfolios, there has been a scarcity of multi-asset, broadly diversified indexes to serve as appropriate performance benchmarks.

MULTIPLE ANSWERS

What is the correct point of reference that could serve as an appropriate performance benchmark for various investment portfolios? There is not just one — in general, advisors must construct a benchmark that mirrors the portfolios they construct. The "Got Benchmarks?" table on page 106 proposes appropriate benchmarks for various investment portfolios.

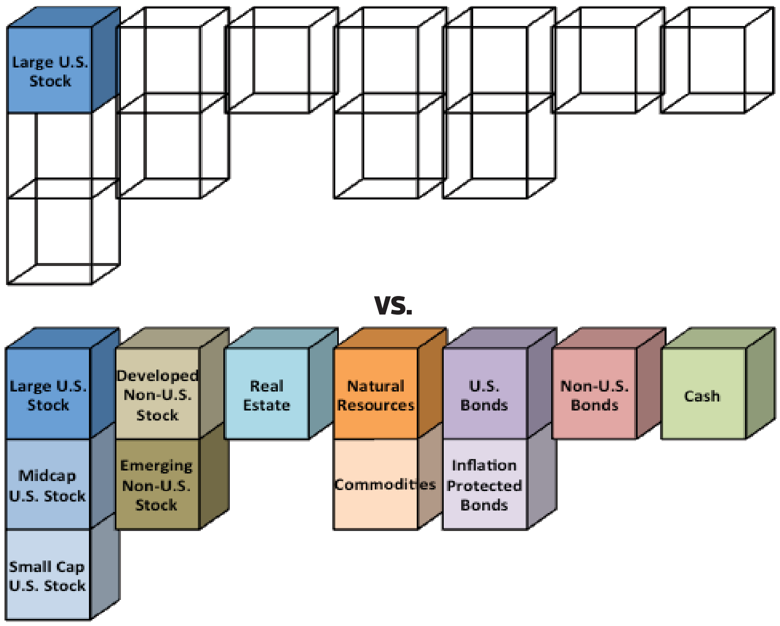
Not all of the portfolios cited in the table are fully diversified, of course; the sad reality is that far too many portfolios are not. For instance, the classic balanced fund is still basically a two-asset model comprising 60% U.S. large-cap stock and 40% bonds. Likewise, many 401(k) accounts are populated with a relatively small number of mutual funds, most of which are large-cap U.S. stock funds. Investors who try to diversify by picking several differently named funds often end up with a redundant mix of domestic equity funds.

Yet even under-diversified portfolios need good benchmarks. If a portfolio is composed primarily of large-cap U.S. stocks (with, say, 80% or more), then the S&P 500 is an appropriate benchmark. And if a portfolio is primarily a mixture of U.S. stocks and U.S. bonds, a likely benchmark would be Vanguard Balanced Index, based on a mix of 60% large-cap U.S. stocks and 40% U.S. bonds.

In the late 1930s when that 60/40 model was created, there were very few asset classes available to mainstream investors — so a model that included stocks and bonds came close to covering the waterfront. But the

BAD BENCHMARKING

The S&P 500 is not an appropriate performance benchmark for a portfolio with multiple–asset classes.



wide variety of asset classes now at an advisor's disposal renders a two-asset model rather obsolete.

A portfolio now is more likely to hold a broad selection of asset classes, including U.S. stocks of various sizes, non-U.S. stocks, real estate, resources and commodities, U.S. bonds, non-U.S. bonds and cash. For such a multi-asset portfolio, you could use the 7Twelve Index, calculated by S&P Custom Indices and – full disclosure – based on the model I've created, as a benchmark.

DO YOU MEASURE UP?

The next step for most advisors is to compare a portfolio's performance to the benchmark's returns. The chart on page 106, "How the Benchmarks Fare," shows the annualized performance of several key benchmark indexes over several time periods ending Dec. 31, 2013.

The performance difference between the asset classes (and, thus, the benchmarks) can be large. Consider the performance differential between U.S. bonds (Barclays Capital Aggregate Bond index) and U.S. large-cap stocks (S&P 500). U.S. bonds actually outperformed U.S. large-caps over the past 15 years, from 1999 to 2013. Yet in 2013, the performance difference was enormous: -2.02% for bonds vs. 32.41% for stocks.

And in any event, you wouldn't want to benchmark a stock portfolio by comparing its returns to a bond index.

Another reason to consider not using the S&P 500 as a benchmark is the huge range in its annualized returns – from 4.68% to 32.41%. If one

GOT BENCHMARKS?

See the best benchmark for various types of portfolios.

What's in the Portfolio?	Appropriate Performance Benchmarks
Primarily large U.S. stocks	S&P 500
Primarily small U.S. stocks	Russell 2000
Primarily stocks in developed non-U.S. economies	MSCI EAFE
Primarily stocks in emerging non-U.S. economies	MSCI EM
Primarily U.S. bonds	Barclays Capital Aggregate Bond
Primarily publicly traded REITs	Dow Jones U.S. Select REIT
Primarily commodities	Deutsche Bank Liquid Commodity
Primarily cash	3-month Treasury bill
Primarily large U.S. stocks and U.S. bonds	Vanguard Balanced
Broad mixture of 12 different asset classes	7Twelve

of the goals of an investment portfolio is consistency of returns over time, advisors will again benefit from using a multi-asset index, whose annualized returns have ranged more narrowly between 5.61% to 11.2%.

The S&P 500 will often outperform a broadly diversified index during shorter (one-, three- or even five-year) time periods. But the volatility and occasional large declines of such a nondiversified index will generally undermine its longer-term performance.

All of this reminds us why the performance of the S&P 500 (or any other single-asset class index) is an inappropriate benchmark for a portfolio that includes a variety of asset classes.

LOGICAL BENCHMARKS

Of course, no matter which benchmark is most appropriate for a portfolio model, the only truly relevant benchmark is one that is specific to the goals and objectives of each individual investor.

The most useful performance comparison is whether the portfolios are moving clients toward their stated goals and objectives in a timely manner and within the parameters of their stated risk tolerances.

In terms of portfolio performance, what else matters? If clients are progressing toward their financial goals, who cares what the S&P 500 did last year?

For instance, a retiree couple's main goal may be to preserve their sizable nest egg by obtaining a modest return while avoiding any significant capital loss. Their performance goal (will likely have little to do with the return of the U.S. stock market, simply because their portfolio may have only small allocations to equity-based investments.

If there are no stated goals, then advisors need to solve that problem before attempting to measure progress or implement a benchmark. Yet for all of your other clients, the best performance benchmark is measuring their timely progress toward financial goals; the second-best benchmark is an index that is similar to the asset mix within their portfolio. **FP**

HOW THE BENCHMARKS FARE

How various indexes performed over multiple time periods ending Dec. 31, 2013.

Benchmark Index	1-Year Annualized Return (2013)	3-Year Annualized Return (2011-2013)	5-Year Annualized Return (2009-2013)	10-Year Annualized Return (2004-2013)	15-Year Annualized Return (1999-2013)
Barclays Capital Aggregate Bond	(2.02)	3.28	4.46	4.55	5.24
S&P 500	32.41	16.18	17.93	7.40	4.68
MSCI EAFE	22.79	8.17	12.44	6.91	4.54
Vanguard Balanced (60% stock/40% bonds)	17.96	10.99	13.18	6.90	5.65
7Twelve (calculated by S&P Custom Indices)	9.24	5.61	11.20	7.84	8.72

Source: Lipper, author calculations

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