

Everything You Wanted to Know About Equity Performance Benchmarks

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Overview

Major advancements in performance benchmarking provide a broad array of tools for evaluating investment performance, but they also create an increasingly complex variety of benchmarking choices. An examination of the results of three distinct but related studies provides insight into the benchmark selection process. Understanding how to select the most appropriate benchmark makes it easier to take advantage of these advancements and, ultimately, leads to better identification of manager style and skill.

The question, "How are your investments performing?" is often answered with another question, "Relative to what benchmark?" In this article, we review equity benchmarking, take a look at the current state of the art, and offer our perspective for selecting the most appropriate benchmark.

One basic purpose of performance benchmarks is to provide a simple passive alternate return that investors could have obtained rather than the active returns they did obtain. Another is to help establish expectations for the pattern of returns to be delivered in the future. The first benchmarks measured popular segments of the total market, such as the Dow Jones for those thirty stocks and the Standard & Poors 500 as a proxy for a large portion of the overall dollars in the equity market. These benchmarks served their purpose well in the early days of investing, and still do today when used to gauge the performance of portfolios that reflect the investment styles represented by the respective benchmarks. That said, the art and science of portfolio construction is an evolving process. Today, investment managers create can—and do—create portfolios that are quite different from these popular indexes.

Likewise, investors today have more choices than they did a few years ago when it comes to choosing a benchmark against which they will judge the performance of their portfolios. They can continue with the widely used market indexes, use style-specific indexes, or create custom-blended indexes. This article provides guidance for making decisions concerning these various options by examining three distinct but related studies.

Survey Says...

In June 2003, an Internet-based survey of benchmark practices was conducted among institutional investors and consultants. While the institutional marketplace was the target audience for the survey, advisers to high-net worth investors often utilize the same investment strategies and vehicles employed by institutions. With this in mind, the survey's results are worth considering.

To summarize, most survey respondents rely on both peer groups and benchmarks for evaluating equity manager performance. When it comes to benchmarks, virtually all use broad market indicators, and the vast majority also use style benchmarks. For U.S. equity performance evaluation, most believe that style is very important, but only about a fourth of the respondents think it is very important for evaluating international portfolios. The most widely used market benchmarks are the S&P 500 for U.S. portfolios and the Morgan Stanley Capital International (MSCI) and Europe Australasia and Far East (EAFE) benchmarks for non-U.S. portfolios.

The most commonly used style benchmarks are the Russell indexes for U.S. portfolios and the MSCI for non-U.S. However, it is important to remember that popularity is not necessarily synonymous with quality. While these indexes are the most popular, there are other indexes that may in fact better match the style characteristics of a given manager. In the two studies that follow, our objective is to examine indexes applied by a dozen major firms in an effort to assess which indexes appear to be most suitable for style determination. When reviewing this information, give some thought to your personal portfolio and consider the benchmark or benchmarks against which your investment consultant measures your portfolio.

Best Benchmark Study

One way to find a single benchmark, rather than a blended benchmark, for a specific portfolio manager is to calculate the correlation of that manager's performance with as many benchmarks as possible. The assumption is that the manager's approach is characterized by the benchmark it tracks most closely, as measured by correlation. Of course, the reasons for this close tracking can vary. It's common practice for portfolio managers to control business risk by limiting deviation from a given benchmark when they know that they will be evaluated against a specific index. In these cases, widely used indexes are likely to be the benchmark of choice, so these popular indexes should exhibit the highest correlation. Sometimes though, the manager gives us their best shot, delivering performance rather than tracking a benchmark. In these cases, a high correlation represents a similarity of the benchmark to the manager's philosophy. In any event, it's important to keep in mind that the index with the highest correlation may not actually be the index that best matches the manager's style. The best index, in general, is the one that has the risk/reward characteristics that best match the manager's approach to investing.

A better research approach is to concentrate on skill rather than rewarding a low tracking error relative to a benchmark. Probably the most salient feature of asset-manager attractiveness is investment skill. The search for skill is well served with custom benchmarks, which can be defined as blends of style benchmarks, as described in the next study.

Best Blend of Style Indexes Study

To set the stage for the third study, we have identified the style palettes that work best in returns-based style analysis (RBSA). It's like finding the best color master for creating custom-blended paint. RBSA uses return history and optimization techniques to determine the blend of styles that most closely emulates the behavior of the investment portfolio. Style palettes are the collection of style indexes used in the optimization. The optimal style palettes are those that best explain performance. By definition, RBSA goes beyond the 'best benchmark' search described in the second study.

Conclusion

So here's what we've learned:

- Peer groups are widely used as a performance evaluation tool.
- Style benchmarking is also widely used.
- Off-the shelf benchmarks can be chosen on the basis of highest correlation.
- Custom-blended style benchmarks explain more of the variability in manager returns than do off-the-shelf benchmarks.
- RBSA is a useful tool for constructing custom benchmarks.

Over the years, major advancements in performance benchmarking have been made. Along with these advancements comes greater complexity. The objective of the studies presented in this article is to make it easier to take advantage of these advancements and, ultimately, to lead to better identification of manager style and skill.

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