Benchmarking Principles and Construction

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The Question

“Is my investment manager doing a good job?” Answering this question depends on the desired outcome that the investment manager was hired to produce. Only after the client has taken the time to define their investment objectives are they able to answer this most central question.

The Problem

Predictably, the investment manager, when asked to assess their own effectiveness, will suggest that they are doing a good job and their client’s experience is above average. But it stands to reason that not every investment manager is above average.

And so the client, seeking an unbiased evaluation, queries a competitor to the incumbent manager asking, “Is my investment manager do a good job?” Predictably, the competitive manager can find a long list of reasons why the current manager's strategy and tactics are inferior to their own. The competitive manager will suggest, with great conviction and supporting data, that the client will do injury to themselves and others if they do not fire the current manager and hire them as a replacement because their strategy and tactics are truly above average.

In defense of the investment industrial complex, this frustration of getting a straight answer to a fairly fundamental question is rightly placed at the feet of the clients, NOT the investment manager. It is for the employer to define the job description and conduct the periodic employee review, not the employee. It is for the employer…the capital owner…the client…to define the key performance indicators against which the manager's performance will be assessed. Without established key performance indicators, it is very difficult to answer the question, “Is my investment manager doing a good job?”

The Plumb Line

To thoughtfully answer this question, an investigation of the portfolio's risk and return experience must be made. The evaluation of an investment manager requires tools for determining whether or not the manager took appropriate risk to earn the return needed in accomplishing the investor's objectives. Without these benchmarking tools, no objective judgment about risk and return can be made. Without a plumb line it is impossible to know if the wall is straight.

The Standard for Trustees

Where the client is a trustee and the capital is not their own but held in trust for another, the trustee has an affirmative duty to establish the job description (a "mandate"). The preamble to the Uniform Prudent Investor Act notes, "The tradeoff in all investing between risk and return is identified as the fiduciary's central consideration." Whether the trustee is responsible for an testamentary trust, an ERISA trust or a foundation/endowment, they have an affirmative duty to independently monitor the activities of the agents to whom they have delegated investment duties (California Prudent Investor Act §16052, California Management of Institutional Funds Act §18505(a)(3), ERISA §1104(a)(1)(a)).[1]

Benchmarking Principles

No Perfect Answer: Before a benchmarking analysis begins, one must realize that there is no perfect benchmark that can be constructed to precisely measure the successes or failures in the manager's activities. As such, a *series* of benchmarks should be developed which, each in their own way, help the analyst judge whether the defined investment objectives are being accomplished.

Don't Change the Rules: Once a benchmarking process has been defined, the approach should not be modified unless the client's objectives have changed. Presumably, during the relationship the investment manager will recommend strategic and tactical changes to the portfolio that they believe will either enhance the return or reduce risk. However, these changes in strategy and tactic do not constitute a basis for a change in the benchmarks. The wisdom of these changes

[1] The vast majority of states have adopted the model language from the Uniform Prudent Investor Act and Uniform Prudent Management of Institutional Funds Act and will have substantially similar language.

will be reflected in either increased return for the portfolio or reduced risk as compared to the established benchmarks.

Nothing is Free: The client needs to understand that benchmarks by their nature do not include the cost of products or the fees paid for management oversight which, if considered, would reduce the benchmarks' returns. Most investment managers suggest that their management fee will be more than recovered through the strategic and tactical decisions they make as part of the ongoing management process. If the manager believes that the cumulative benefit of their activities will create a result superior to an unmanaged index, no "fee drag" should be imputed to the benchmarks.

Give It Some Time: In the same way it would be a mistake to too quickly judge the caliber of a professional athlete from their performance in one game, the client should appreciate that it would be a mistake to judge their investment manager's performance from too brief an investment period. To be sure, informed observations can be made throughout the measurement process, but meaningful conclusions can only be reached with a statistically significant sample size which could require a minimum of five years' worth of performance history.

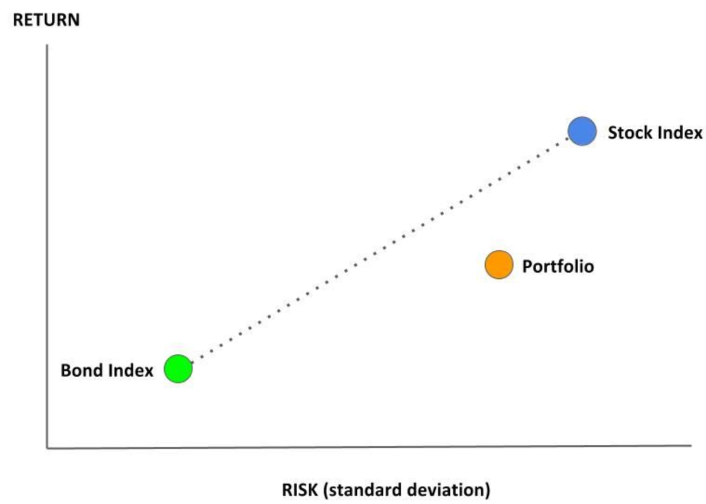
The Most Important Benchmark

Target Return: The most important benchmark to test a manager against is the target rate of return needed to accomplish the portfolio's purposes. Capital is given to an manager to be allocated in such a way as to produce some agreed upon return through investment income, capital appreciation or both. This is the fundamental outcome that the investment manager was hired to produce. To be sure, most investment managers and all compliance departments for those managers will bristle under a documented targeted return that the manager is being hired to produce. But despite the manager protestations that "past performance is no indication of future returns" and that "returns are not guaranteed," they are being hired to create an outcome…a result…a return experience…that is supportive of the capital owner's financial goals and objectives.

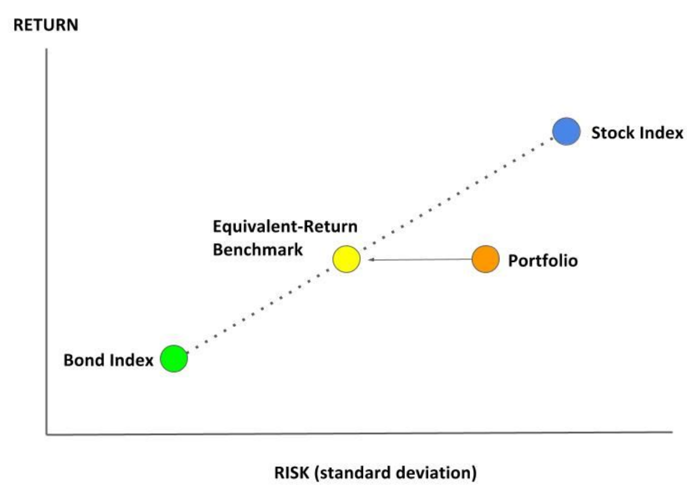
The client and the investment manager they choose for deploying their capital are well served by answering the question, "What return is needed to accomplish my investment purposes?" Very expensive software that takes hundreds of factors and thousands of scenarios into account can be used to answer this question, or a fairly simple spreadsheet can be developed to identify this targeted return objective. But no matter how the answer is arrived at, an answer must be identified.

Retrospective Benchmarking

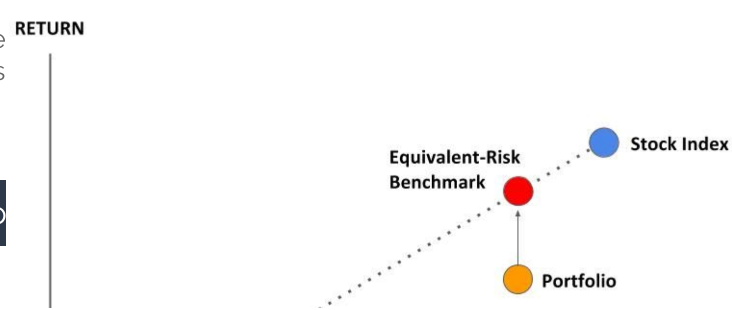
In those cases where the manager was not given a job description at the beginning of the relationship, the actual risk and return of the managed portfolio can be compared to a blended benchmark with similar risk and return characteristics.



In this simple benchmark process, a range of hypothetical portfolios is created by plotting two points on a risk-return graph: one point represents an "all bond" portfolio (**green** point) such as the Barclays Aggregate Bond or Barclays 1-10 Year Muni Index; and the second point represents an "all stock" portfolio (**blue** point) split 70%/30% between the Russell 3000 and MSCI ACWI ex-US (to account for the typical U.S. investor's "home bias"). A line is then drawn between these two points to represent the combinations of stocks and bonds that could've been held over the same period.[2] The managed portfolio (**orange** point) is then plotted on this risk and return graph.



Equivalent-Return Benchmark:
With the data obtained in the above exercise, a point can be identified on the blended index line which represents the combination of bond and stock indexes that would have produced the **same return** as the portfolio during the period (**yellow** point). Holding return constant, we can determine whether the RISK experienced in the managed portfolio was greater or less than the RISK



[2] This simple tool doesn't take into account the
when there are less than perfectly correlated ass
of the manager, not the reverse.

experienced by the blended index combination.

Equivalent-Risk Benchmark:
Conversely, you can also plot on the line a blended index portfolio with the **same risk level** as that of the managed portfolio during the same period (**red** point). This allows you to find how the managed portfolio's RETURN compared with that of the blended index portfolio.

Prospective Benchmarking

The following two benchmarking strategies can and should be established at the inception of the management relationship. They illustrate distinct measurement criteria against which the manager should be measured.

Strategic Benchmark: This benchmark is composed of the following three major asset classes: U.S. stock (represented by the Russell 3000 index), Non-US stock (represented by MSCI ACWI ex-US) and bonds (represented by Barclays Aggregate Bond Index). Since each of these indexes is market cap weighted, there is no preference given to particular sub-asset classes. Every allocation or product decision made by the investment manager is presumed to be made to either increase return or reduce risk in the portfolio. As such, any over or under-performance from the Strategic Benchmark is attributable to the manager's strategic decisions.

Construction of the Strategic Benchmark: First, the initial weighting of bonds in the managed portfolio should be applied to the bond index. All assets not falling into this first category will be presumed to be equity or equity-like in risk and return characteristics and split between the two equity indexes. The weight given to *each* the Russell 3000 and the MSCI ACWI ex-US indexes will then be based on the managed portfolio's actual split between US-based and foreign-based assets. (If certain "alternative" assets are proposed by the manager, see "Benchmarking Alternative Assets" below.)

Tactical Benchmark: This benchmark is designed to match as precisely as possible the investment manager's actual portfolio at the inception of the relationship. The Tactical Benchmark is intended to memorialize for future years how the initial detailed allocation would have performed had the manager made NO changes after the portfolio's initial construction. The manager's subsequent tactical and product level changes will have created a divergence from the initial portfolio allocation's risk and return, and that divergence (whether positive or negative) will be attributable to the investment manager's ongoing management decisions.

Construction of the Tactical Benchmark: The Tactical Benchmark should be constructed using indexes with as much specificity as is reasonably possible given the various products and strategies the manager initially adopted. If it's possible, the actual securities themselves may be used as the benchmark components rather than indexes. Unlike the Strategic Benchmark which is constrained to only three asset classes (US stocks, non-US stocks and bonds), the Tactical Portfolio will include all sub-asset classes that are included in the manager's initial allocation. (Again, if certain "Alternative" assets are proposed by the manager, see "Benchmarking Alternative Assets" below.)

Benchmarking "Alternative" Assets

At times the investment manager will identify so-called "alternative" investments that they expect to produce a distinctly different risk and return experience from the other assets within the portfolio. But the precise definition of "alternative" is something of a moving target. Some managers call commodities, MLPs, and real estate "alternative", and others describe private equity, hedge funds and structured notes with the same moniker. Good benchmarking begins with precision of terms. We offer the following definition of "alternative" asset classes to help clarify the ambiguity. "Alternative" investments are defined as products or securities where (1) the underlying holdings are not clearly identified or valued on a daily basis (**lack of transparency**) and/or (2) the investment cannot be liquidated within a 2-day settlement period (**lack of liquidity**). Following are several examples of how this definition would be applied to investments that are frequently defined by the industry as "alternative":

Product / Strategy	Transparent	Liquid	Asset Type
Hedge fund with 30-day lockup	No	No	Alternative
"Liquid Alt" (40 Act hedge fund)	Yes	Yes	Equity
REIT	Yes	Yes	Equity
Syndicated real estate deal	Yes	No	Alternative
MLP fund with 30-day lockup	Yes	No	Alternative
MLP security	Yes	Yes	Equity
Structured note	Yes	Yes	Equity
Covered call writing strategy	Yes	Yes	Equity

In those instances when an "alternative" asset (consistent with the definition above) is recommended, the client should require that the manager provide the following documentation for the Trustee's records:

1. A description of the investment,
2. Anticipated risk/return characteristics,
3. The term of the investment,
4. The schedule for capital contributions, and
5. A summary of the fees the manager will receive by introducing the investor to this particular investment or strategy.

<u>Benchmarking "Alternative" Assets that Provide Monthly Valuation</u>:
Some "alternative" investments, like many hedge funds, master limited partnerships or structured notes, *do* provide monthly valuations from which time-weighted rate of return (TWROR) can be calculated and risk analysis conducted. If the investment manager's initial proposal includes assets which (1) are considered "alternative" according to the above definition, and (2) *do* provide monthly performance data, the asset should be *included* in the portfolio's regular performance reporting and represented by the U.S. Treasury Bill Index in both the Strategic Benchmark and Tactical Benchmark. The expectation is that these "alternative" strategies will both earn a higher return than Treasury Bills, but also contribute greater volatility to the total portfolio. The benefit, as measured by additional return, and the cost, as measured by increased risk, will be observable in the deviation of the portfolio from the benchmarks.

Benchmarking Alternative Assets that do NOT Provide Monthly Valuation:
Another class of "alternative" investments, like private equity funds and real estate partnerships, provide valuations less frequently than monthly, which makes return and risk calculations less appropriate. Also, those assets that do not provide monthly valuation tend to give the manager or general partner the ability to control the timing and size of cash flows to the investors. As such, those assets that do not have monthly valuation or where the manager retains the ability to affect the timing of cash flow are more appropriately measured with an internal rate of return (IRR) rather than a time-weighted rate of return (TWROR) calculation. These assets will be *excluded* from the portfolio's regular performance reporting and will not be represented in the Strategic Benchmark and Tactical Benchmarks. Instead, these investments will have their performance measured against a distinct *Inflation+5%* return benchmark and/or other benchmark that has reasonably similar risk and return characteristics.

Putting It All Together

Following is a summary of the various benchmarks we have identified to measure the manager's activities against. It is a best practice to ask for this reporting for two measurement periods--since inception and year-to-date. As noted above, there is no perfect benchmark, and so a series of benchmarks is needed to converge upon the answer to the question, "Is my investment manager doing a good job?"

Benchmark Name	Description
Targeted Rate of Return	The long-term annualized return needed to accomplish the investor's goals.
Strategic Benchmark	US stock, non-US stock, bond (and potentially Treasury Bill) indexes in proportion to that of the manager's initial allocation.
Tactical Benchmark	Blend of sub-asset class indexes that matches as precisely as possible the manager's initial allocation.
Equivalent-Return Benchmark	That blend of stock and bond indexes that would have produced the same return as the manager actual portfolio (for purpose of comparing RISK).
Equivalent-Risk Benchmark	That blend of stock and bond indexes that would have produced the same risk as the manager actual portfolio (for purpose of comparing RETURN).

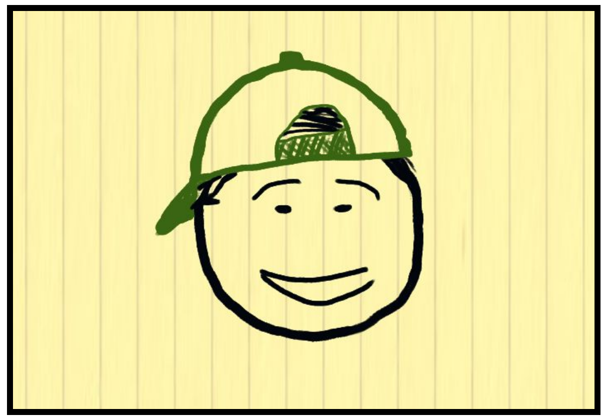
What the Manager Will Say

Some managers will object to this level of scrutiny being placed on their activities. *They* would prefer to be responsible for the benchmarking process by which they are measured--both in setting the benchmark and providing the measurement comparisons.

The manager is welcome to offer input on other benchmarking principles or construction strategies that they feel will improve this governance process. The client should be comfortable including additional benchmarks that the manager believes better represent the portfolio's risk and return characteristics. However, the review process offered here should *not* be modified in response to the manager's objections or the strategic or tactical changes they suggest. Remember, employees don't get to write their job description or conduct their own annual review. The wall does not get to tell the builder it is straight.

About Anodos

Anodos helps capital owners develop and manage an investment governance process. For many of our clients this oversight responsibility is not merely a subject of curiosity, but a duty they are obligated by statute to fulfill on behalf of the beneficiaries and organizations they serve. What makes Anodos unique is this is all we do. We don't manage money, sell insurance, or accept referral fees. We don't have a horse in the race.



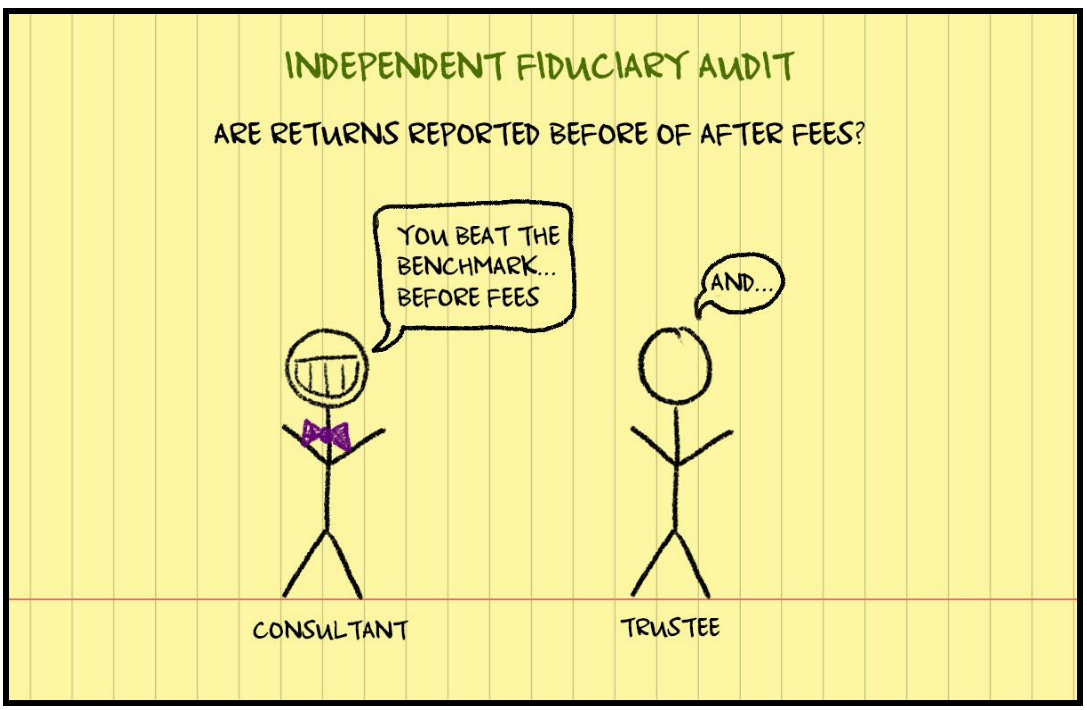
Josh Yager, Esq., CFP®, ChFC®, CLU®

Josh is a recognized content expert on the issues of fiduciary duties relating to the management and oversight of trust assets. He lectures extensively on the policies and procedures for conducting investment manager audits to CPAs, attorneys, and professional fiduciaries throughout the country. Josh is Managing Partner at Anodos Advisors and a licensed attorney. Prior to founding Anodos in 2005, Josh worked for fifteen years as an investment advisor with Mercer Advisors.

Ryan Wolfshorndl, CFA, CIPM, CFP®

Ryan has been with the firm since its inception in 2005 and holds the Chartered Financial Analyst and Certified Financial Planner designations. Ryan is a Partner and has 12 years of experience conducting performance attribution and other statistical analysis relevant to the investment experience. This work ensures accountability, adherence to investment parameters, and clarity of expectations between clients and their managers.


IS 7% A GOOD RETURN?
B
7%
A
START
END
IT DEPENDS ON HOW MUCH RISK YOU TOOK TO GET 7%.


INDEPENDENT FIDUCIARY AUDIT
ARE RETURNS REPORTED BEFORE OF AFTER FEES?
YOU BEAT THE BENCHMARK... BEFORE FEES
AND...
CONSULTANT
TRUSTEE