The Colony Group

PERSPECTIVES
Institutional Series

HOW AND WHEN TO USE A BENCHMARK

What purpose do benchmarks serve?

Rob Inches: Benchmarks can help provide institutions with a framework for achieving successful long-term investment results. Once risk and return objectives have been codified, a system to measure progress will be needed. Thoughtfully selected benchmarks are helpful for understanding portfolio performance over time and are additive to an institution's portfolio construction process.

Can benchmarks serve as a useful tool in monitoring portfolio risk?

RI: Absolutely. While risk management should focus on the risk of permanent loss of capital, portfolio drawdown, and correlation of investments, too often investors focus on the risk of underperforming a benchmark, leading to unintended outcomes. The risk metrics underlying a benchmark are always changing. Institutions need to factor these changes into their decisions to manage their risk allocation.

How does one choose an appropriate benchmark?

RI: The primary objective and responsibility of an institution's asset manager is to construct and manage a portfolio that meets or exceeds its return and risk objectives. The measurement of success should be performed over a prescribed, long-term time frame against an appropriate benchmark(s), as defined in the institution's investment policy statement (IPS). Defining an absolute benchmark (net of inflation), typically derived from a combination of an institution's annual spending/draw requirement and its risk (maximum drawdown) tolerance, and a relative benchmark derived from the strategic asset allocation targets set forth in the IPS can be very effective.

What should one be aware of when considering benchmarking investment progress?

RI: Read the small print. The investment management industry is masterful at presenting performance numbers in the most favorable way. Institutions need to understand why a benchmark was chosen and whether it provides a fair comparison. Typically, performance reporting includes footnotes which provide important information. Always take a moment to read the footnotes and understand what they mean.

How should one think about periods of outperformance and underperformance?

RI: It is rare that institutions will consistently outperform a benchmark. When periods of underperformance do arise, a clear understanding of why can lead to better long-term decisions. Patient investors typically benefit from the compounding of returns in a well-constructed portfolio.

Can benchmarks help generate alpha?

RI: Alpha generation (excess return over the benchmark) is the value added by great managers. Alpha exists for a discerning investor with patience and access. Proper understanding of comparative benchmarks can help investors identify managers who have developed a process for generating alpha.

What does it mean to be benchmark agnostic?

RI: Benchmark agnostic is a compelling concept. It supports the notion that benchmarks are often overused and underscores the need for good investing.

When should one avoid using a benchmark?

RI: There are many instances where benchmarks can lead to poor decisions. For example, investors will often chase the "hot manager", when it is a bull market they are chasing. Sometimes identifying the great manager experiencing a period of underperformance is the better approach.

ROB INCHES

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As a Senior Portfolio Manager in the Institutional Advisory Practice team at The Colony Group, Rob provides comprehensive solutions to the investment, wealth planning and philanthropic needs of owners and stewards of substantial capital. Rob is a financial professional with more than 34 years of experience in the wealth management industry.

Rob has written on alternatives to fixed income, redefining growth and value investing, the impact of innovation on investment decisions and ensuring a successful family legacy. Rob's experience gives him a perspective on all aspects of family legacy planning with an emphasis on investing.

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