Portfolio Benchmarking

When planning for the future, individuals, many times with the help of their advisors, create financial plans that incorporate a wide range of objectives such as the purchase of a new home, saving for retirement, funding college expenses, etc. The achievement of these objectives is highly predicated on two basic principles:

1) The simple exercise of saving. - - - Although not all objectives in life are financial, those that do revolve around finances will not be achieved unless funds are set aside to meet the specific goal.

2) The growth of saved assets. - - - This is especially important for longer-term financial objectives where the "power of compounding" can be significant.

Although there is typically a lot of planning involved with the first basic principle listed above, we are going to concentrate this discussion on the second principle outlined (i.e. "The growth of saved assets"). We will briefly discuss the components involved in developing an investment strategy and we will then focus on the challenges faced when measuring portfolio performance (i.e. benchmarking).

A key component of developing an investment strategy includes clearly outlining each client's risk profile and investment constraints, which are essential ingredients in the proper creation and management of their portfolio. For example, a client's time horizon, liquidity needs, tax positioning and willingness to accept market volatility all represent potential constraints that affect portfolio construction. Outlining the risk profile and all potential portfolio constraints allows for the setting of realistic return expectations and for the proper assessment of progress towards goals.

It is also important to highlight that investments earmarked for different objectives will likely have different growth expectations, which will impact the benchmarking of these investments. For example, if you are age 45 with a 17-year old child, it would not be realistic to expect investments that have been set aside for college to earn the same rate of return as investments you have set aside for retirement. These two objectives have much different time horizons and the investments set aside to meet these objectives should be benchmarked separately. The college funds will likely be much more conservatively invested since it would be difficult to recover from a sharp market downturn. On the other hand, the retirement funds have "the benefit of time" and, theoretically, could be invested much more aggressively. If interested, we discuss more about the process of determining risk profile and how to invest funds with differing objectives in our 2nd quarter 2016 webinar, which can be found on our website at www.silveroakwealth.com.

Once you have developed and executed an investment strategy that is aligned with a specific objective, the next step is to properly measure the performance of the strategy over time (i.e. benchmarking). Although developing and executing an investment strategy can be a complex process for many individuals to undertake on their own, properly benchmarking the strategy can be even more challenging for most investors. This is due to the fact that simply comparing the overall return of a portfolio, or even single investment, with a broad based index, such as the S&P 500 Index, is likely not an accurate or fair comparison.

The media, and even many investors, frequently misunderstands what market indices represent and refer to them inappropriately. For instance, the Dow Jones Industrial Average Index is often quoted when discussing U.S. equity and economic performance, as it is the oldest U.S. index. However, it might not be the best representation of the broad U.S. equity markets. Likewise, many investors simply compare their investment performance with one of the widely known indices that dominate media coverage, such as the S&P 500 Index. However, both the Dow Jones Industrial Average Index and S&P 500 Index focus exclusively on U.S. large company stocks at the exclusion of U.S. small company stocks, international stocks and bonds. Therefore, if you have invested in a diversified strategy neither of these indices would be a good proxy for your portfolio.

Since investors often use "benchmark" and "index" interchangeably, when in fact they are distinct terms and concepts, below we will help define the differences. We will also further discuss the concept of "benchmarking" and how indices are used in this process.

What is an index?

- An index represents a certain segment of the market, such as the Dow Jones Industrial Average Index which represents 30 of the largest and most well-known U.S. public companies. There are thousands of indices as the market can be segmented in many different ways. Common ways the market is segmented include: market capitalization (large, mid, small), regions (domestic, international, emerging markets), style (growth, core, value) and sectors (financials, technology, health care, etc.).

- Indices can be created by weighting companies based on market cap (larger companies have higher weighting), price (companies with a higher stock price have higher weighting), equal-weight (each company has same weight), fundamental factors (ex. valuation, sales and earnings growth, dividends), etc.

- There are multiple indices for each asset class – i.e. equities, fixed income, commodities, etc.

Below are several of the more commonly referenced indices along with a description of how they are constructed.

Index	Description
Dow Jones Industrial Average Index	Price-weighted average of 30 U.S. large capitalization companies
NASDAQ Composite Index	Market-cap weighted index of 3,000 companies listed on the NASDAQ stock market. The index is heavily weighted towards technology and growth companies.
S&P 500 Index	A broad market-cap weighted index of the largest 500 U.S. companies.

Index	Description
Russell 2000 Index	Market-cap weighted index capturing the smallest 2,000 companies in the Russell 3000 (which is the largest 3,000 companies in the U.S.)
MSCI EAFE Index	International index representing 21 developed countries in Europe, Australia and Asia.
Barclays U.S. Aggregate Index	Broad market-cap weighted fixed income index representing investment grade bonds in the U.S. It excludes municipal bonds and TIPS.

Broad indices, such as the Dow Jones Industrial Average Index and S&P 500 Index, generally have relatively close performance since they both measure U.S. large company stocks. However, even indices that compare similar parts of the markets can have significantly different performance due to the construction rules of each index and their specific underlying make-up. For example, the Russell 2000 Index, S&P Small Cap 600 Index, and the CRSP U.S. Small Cap Index all represent U.S. small cap stocks. However, as you can see from the table below, their annual performance has deviated widely over certain timeframes.

	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016 YTD
Russell 2000 Index	-1.57%	-33.79%	27.17%	26.85%	-4.18%	16.35%	38.82%	4.89%	-4.41%	11.01%
S&P Small Cap 600 Index	-0.30%	-31.07%	25.57%	26.31%	1.02%	16.33%	41.31%	5.76%	-1.97%	13.62%
CRSP US Small Cap Index	1.99%	-36.81%	40.11%	27.98%	-1.85%	18.59%	38.48%	7.54%	-3.68%	10.77%
Max Difference	3.56%	5.73%	14.54%	1.67%	5.19%	2.27%	2.84%	2.65%	2.44%	2.85%

As of 10/6/2016

What is a benchmark?

- Benchmarks are used as a point of reference for the measurement of investment performance. For appropriate comparison purposes, it is important that the benchmark is a good representation of the investment it is being compared against.
- Indices are often used as benchmarks. However, peer groups (i.e. other similar investments) could also be used as a benchmark.
- The most common indices used as benchmarks are S&P 500 Index for U.S. equities, the MSCI EAFE Index for international equities, and the Barclays U.S. Aggregate Index for U.S. bonds.

What are the benefits of benchmarks?

- Benchmarks give investors a tool to assess relative investment performance across different investment strategies.
- Benchmarks provide a point of reference to hold investment managers accountable for their performance and investment thesis.
- Benchmarks help establish investor expectations for long-term growth, which can then be incorporated into their comprehensive financial plan.

What are the limitations of benchmarks?

- Many investors incorrectly compare their overall portfolio performance to a single benchmark, such as the Dow Jones Industrial Average Index or the S&P 500 Index. However, almost all financial objectives require some diversified investment strategy utilizing a combination of U.S. stocks, international stocks and bonds. It would be inappropriate to compare the performance of a globally diversified portfolio of stocks and bonds to the Dow Jones Industrial Average Index or S&P 500 Index, as they have different risk/return profiles.
- A major drawback of using indices as a benchmark relates to the underlying construction issues and biases. For instance, market cap weighted indices can be susceptible to the concentration of risk in sectors, geographies or in individual holdings. This typically occurs after sectors or regions have outperformed for a multi-year period. For instance, the energy sector grew to about thirty percent of the S&P 500 Index by the late 1970s. Other notable sector concentrations include technology in the late 1990's and financials in the mid to late 2000's.
- As noted previously, there can be wide deviations of returns among indices that are designed to measure similar parts of the market. Investors utilizing only one index can be misled about relative performance without looking at returns from multiple indices.
- Bond indices generally have a unique drawback of concentrating exposure to less creditworthy companies and countries. Unlike equity indices where larger companies are typically of higher quality, bond indices typically give higher weighting to companies and countries with larger amounts of debt.

How does SilverOak utilize benchmarks?

At SilverOak, we first assist our clients in developing a comprehensive plan designed to meet each of the individual financial objectives, whether that be the purchase of a new home, saving for retirement or funding college. This plan sets the foundation and typically includes, among several other items, annual savings targets and possibly multiple investment strategies. Not all financial objectives have the same investment strategy due to time horizon and liquidity needs, as highlighted by our example of college funds being invested more conservatively than retirement savings. Therefore, it is important that we properly set return expectations and benchmarks that reflect comparable risk/return profiles.

SilverOak strives to provide information to assist our clients in measuring the progress they are making in achieving their financial objectives and in evaluating the performance of their investment portfolio. We use performance reports as one assessment tool along with other reports such as financial plans and net worth statements. The proper selection of appropriate benchmarks is very important for reporting and reviewing investment returns. However, how the benchmark data is utilized can be just as significant. At SilverOak, we are cognizant of providing useful data that guides correct decision making. In utilizing these reports, we often remind our clients that short-term results should not dictate the long-term investment strategy. There can be good reasons for performance to deviate from a benchmark. For instance, it would be prudent to maintain a cash reserve in anticipation of making large tax payments or paying for large home projects over the next 6-12 months. The cash reserve would maintain liquidity so the client can meet their financial objectives. However, the portfolio's performance may appear to underperform a fully invested benchmark as a result of the "cash drag". By avoiding behavioral biases that can arise with short-term performance analysis, we assist our clients in achieving their long-term financial targets.

As part of our internal due diligence process, we analyze our investments against multiple benchmarks, including both peer groups and various indices. Our client performance reports provide a concise outline of portfolio positions, allocation and relative performance against various indices. Although these reports are provided each quarter and can be a valuable resource for information, we encourage all investors to maintain a much longer-term perspective. Returns can be volatile over the short-term, but typically this volatility diminishes as the time horizon extends. In addition, it is natural for strategies to go in and out of favor over various market cycles. As a result, investors should avoid focusing on shorter-term performance and instead concentrate more effort on whether they are meeting their overall financial objectives, which may not always be quantifiable.

Our SilverOak team of advisors provide sound recommendations and strategies backed by research, analysis and years of experience. We are dedicated to establishing a partnership built on trust and to provide customized comprehensive planning solutions that meet our client's short and long-term goals. We are committed to our clients and the achievement of their objectives – not just for today but well into the future – creating a secure foundation for generations to come.