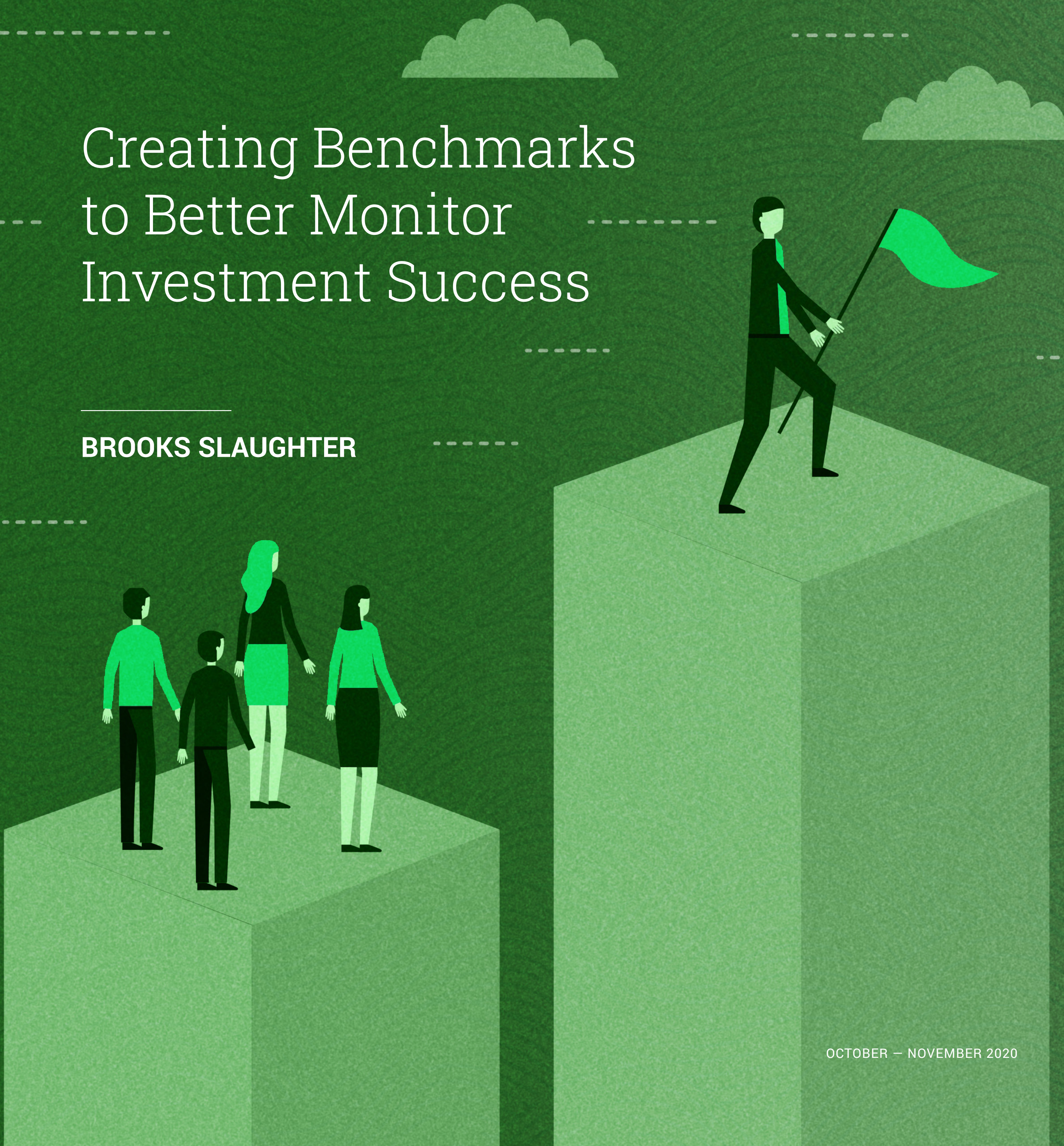
ON COURSE

Creating Benchmarks to Better Monitor Investment Success

BROOKS SLAUGHTER



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> **There's been nothing typical about 2020 by any measure. The year began with a strong economic outlook that appeared mostly impenetrable.** Then, a never-before-seen virus swept the globe and forced the hibernation of every economy around the world resulting in skyrocketing unemployment and plummeting markets. And as the markets recovered, a trend in return variances by investment style magnified. This trend has resulted in many investors scratching their heads as they try to evaluate the effectiveness of their overall strategy and individual investment choices.

The good news is, despite all the disruption readily apparent on the surface, there are many tried-and-true investment benchmarking strategies and principles that can still be applied to provide reliable guidance. And by choosing appropriate benchmarks, you can still reasonably judge your investment success even as volatility and return variances continue into the foreseeable months.

With that in mind, here are some of our thoughts on effective ways to make these analyses, both in the short- and long-term.

What is meant by 'return variances for different investment styles?'

When attempting to evaluate the performance of the market, we have found most investors seek a single-market index as a measuring stick. However, using a single-index strategy for benchmark construction can be frustrating and misleading; here's why. Most investors with an intentionally diversified strategy are often allocated in U.S. and international stocks (of varying styles, sectors, and regions), foreign and domestic fixed income markets, real estate, commodities, and various alternative and non-traditional holdings. These investment classes, with different risk profiles and return expectations, as well as varying sectors and styles, can and will perform very differently as economies cycle and market sentiment fluctuates.

For instance, in the U.S. stock market, many companies attract investors through regular dividends (often called value stocks). Others pay no dividends and choose to use those funds to grow the company more rapidly (or growth stocks) attracting investors seeking growth through price appreciation. This year, we have seen a significant performance difference in these two investment styles. For the year, growth stocks have outperformed value stocks by nearly 30% (growth stocks are up 20% while value stocks are down 10%) — continuing a multi-year trend in these two styles.

There have also been significant performance differences in investment sectors this year. For example, tech stocks, on average, are up over 30% for the year while energy stocks are down 46% and financial stocks are down 16%. These aren't unheard of differences, but certainly rare and all investors should be mindful when trying to evaluate their portfolio for performance and exposure to risk.

Strategies to gauge your investment success in volatile markets

Benchmarks are a useful tool in helping to assess investments. They are intended to help the investor to evaluate the performance of their portfolio in context to the performance of similar investments and risk. Once you have identified the different parts of your portfolio strategy (by style, sector, region, and risk), you are ready to build an appropriate benchmark.

es, to measure your investment success can be challenging. Getting lost in the myriad index choices is easy and leads many to gravitate to a single index. We are not proponents of this strategy, however, as most indexes don't allow the investor to make an apples-to-apples comparison to their portfolio.

"Once your benchmark is built properly, you can determine if your performance is adequate for the risk level taken."

The most used building blocks of benchmarks are market indexes, of which there are hundreds to choose. Indexes typically track a single style (i.e. large, mid, or small company), or sector (i.e. technology, healthcare, financials, etc.). They can also track regions like U.S. stocks or foreign markets. Understandably, these indexes will often perform very differently depending upon their holdings.

Finding the right index, or combination of different index-

One of the most common single index benchmark strategies is to use the S&P 500 index — a market capitalization-weighted index of the largest 500 U.S. publicly traded companies. This means the index is only the largest of domestic companies and the value of the index gives a larger percentage of its valuation based on the size of the company. More precisely, the largest 10 companies in the index of 500 stocks make up 27% of the index value. Therefore, just a small number of individual stocks (60% being technology companies) dominate the index value and performance. It is this characteristic of the S&P 500 that discourages us from using it as a meaningful benchmark for a diversified portfolio.

Instead, we recommend incorporating multiple indexes into a mix that best mirrors your personal need for investment risk and portfolio allocation. This strategy allows an evaluation of active allocation choices as well as the performance of your portfolio's individual components. Again, making the choice of which individual indexes to use for the analysis can be complex. To optimize this exercise, you need a very good understanding of your total portfolio risk as well as your exposure to the portfolio's investment characteristics (style, sector, region, and risk). Then, choose the indexes that best match your portfolio components.

Once your benchmark is built properly, you can determine if your performance is adequate for the risk level taken. Furthermore, it should be clear if the allocations to differing market characteristics are keeping up with their peer group.

Also, don't be discouraged if all your investment choices don't out-perform their relative benchmark over a short-term basis (less than 1-year). However, do look for significant return differentials as you compare your portfolio to the markets. We use such analysis to identify trends and opportunities as well as the effectiveness of internal investment strategy decisions.

Should you ever change your benchmarks?

As long as the indexes you are using maintain their composition, there shouldn't be a need to change them as components of your benchmark. However, how you allocate amongst them could change.

As the need for risk in your portfolio changes, so will the individual investments you use to generate growth, income, and stability. And your benchmark used for evaluating the success of the strategy should be adjusted along with it.

At Slaughter Associates, we maintain a disciplined approach to the selection of and allocation to indexes used to build our various risk benchmarks. Then apply the appropriate risk benchmark to individual portfolios. When changes in our clients' lives precipitate a need to adjust risk in their investment strategy, we make comparable changes in the risk benchmark, as well.

Performance benchmarking isn't a perfect science, but if done with proper consideration, an investor should be able to adequately judge the overall effectiveness of investment strategies.

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