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The Role of Benchmarks in Assessing Risk and Return

1 WHEN IN THE INVESTMENT PROCESS SHOULD I CONCERN MYSELF WITH THE DECISION ON BENCHMARKS?

Benchmark discussion can begin as part of your Pension Plan's investment strategy process. The selection of the appropriate benchmarks is one of the first steps to defining and achieving the Plan's investment objectives. Not all indexes are benchmarks and not all benchmarks are the same.

2 WHY SHOULD I SELECT A BENCHMARK?

In order to analyze, set, implement and assess your Plan's investment policy you should select a benchmark for each asset class identified as part of your Plan's objectives. It's important to choose benchmarks that best fit the definitions of your policy asset classes such as Equity, Fixed Income, and Commodities. For purposes of discussion we will continue the subject with regard to equity benchmarks only.

Benchmark selection can provide critical information in the assessment of your Plan's risk and return. It should be a proxy for the equity asset class (and sub-asset classes) in your investment strategy. It should also be used to monitor your allocation policy and evaluate the performance of your portfolio(s) and manager(s).

3 ARE THERE ANY STANDARD CRITERIA FOR SELECTING GOOD BENCHMARKS?

Since benchmark selection is ultimately dependent on a particular investor's objectives and needs, no one benchmark is the "best" in all cases. Understanding the philosophy and methodology of the different index providers is helpful in determining the usefulness of their associated benchmarks.

The production of indexes involves compilation, calculation, maintenance and dissemination. And while there are differences between the various major index providers, there are some commonly accepted criteria for consideration when choosing among various benchmarks.

One of the major criteria is "market representation". Does the benchmark effectively represent the asset (or sub-asset) class? What constituent securities are selected for inclusion in the index and what data is accumulated to calculate the index?

The answer—select a benchmark that represents the full opportunity set of returns for the designated market space.

There are indexes covering multiple slices of the equity market. The equity market is typically segmented into sub-asset classes by market capitalization ranges such as Large-cap, Mid-Cap, Small-Cap and Micro-Cap. In addition, the equity market is frequently segmented by style into the Growth and Value categories.

Each index provider employs its own methodology for selecting, weighting and mapping stocks into classes and segments. Differences in these methodologies account for significant differences among benchmarks. Therefore understanding how a benchmark is constructed in terms of market representation and segmentation is critical to selecting the best benchmark for your Plan. It is important that the benchmarks match your Plan's objective while accurately representing the neutral position of hired money managers.

Another key consideration in evaluating a benchmark is the set of rules that govern the benchmark.

Is the benchmark constructed in a disciplined and objective manner? Are the rules well established and public. A benchmark built with an objective and transparent set of rules will be predictable and understandable in terms of how the index will reflect market developments. Investors and managers should be able to rely on the benchmark without unnecessary risk of surprises.

Another consideration is whether or not the benchmark is investable. The benchmark should represent securities that are available for investment. For example, an index that is weighted by float adjusted market capitalization effectively reduces the weightings of stocks with large private or government ownerships, or other restrictions on trading.

Another recognized consideration in evaluating benchmarks is the impact of turnover. Part of index maintenance is reconstitution and rebalancing of components. One of the larger costs in benchmarking a portfolio against an index is the turnover cost involved trading in and out of stocks as necessary to keep up with the reconstitution and rebalancing of the index.

4 IS THERE AN EXAMPLE OF HOW DIFFERENCES IN METHODOLOGY FOR DETERMINING SIZE SEGMENTS BETWEEN LEADING BENCHMARKS MATTERS?

Because benchmarks differ from provider to provider, what one benchmark provider calls a broad-market benchmark might be labeled a large-cap benchmark by another. Likewise, there are various alternatives for measuring the small-cap market space, and so on. For example, many investors use the S&P 500 index as their broad market benchmark while others consider it their large-cap benchmark. In fact, however, the S&P 500 includes component securities that rank as far down as 1788 in market capitalization (as of September 30, 2005).

5 ARE THE VARIOUS SIZE/STYLE BENCHMARKS REALLY DIFFERENT AND DOES IT REALLY MATTER TO MY PLAN'S ASSESSMENT OF RISK AND RETURN?

Market representation is very important to the usefulness of a benchmark. The methodology used to classify stocks into the different size and style indexes will affect the benchmark in a portfolio's return. This in turn, affects the ability to measure a money manager's investment skill.

It might seem strange that a stock can be considered both growth and value, or both large-cap and small-cap at the same time. But some benchmarks categorize middle-of-the-road stocks into multiple categories. Take note if you are asking managers to track benchmarks that take this blended approach. You can end up with different investment managers targeting some (or many) of the same stocks and market segments, and in the process inadvertently affect the risk balance that was originally budgeted. For example, if your small-cap benchmark and your micro-cap benchmark share many of the same component stocks, separate money managers charged with investing in small-cap and micro-cap market segments may be weighted in many of the exact same stocks. Therefore, your Plan's risk exposure may be tilted in an unintended direction and you may not be getting the discrete exposure and diversification set by your asset allocation strategy.

The same holds true for the Style benchmarks where growth and value segments are not mutually exclusive. Growth managers may invest in some value stocks and value managers may invest in some growth stocks. This overlap can make it difficult to understand the benefit that a specific style manager is delivering because he or she is allowed to pick stocks from the "other" style. The benchmark should be able to provide information as to whether or not a manager is delivering skill at picking stocks in his or her investing style. In assessing return, it is important to be able to attribute performance to stock selection versus style.

6 SHOULD SIZE/STYLE BENCHMARKS OF MY MANAGERS ADD UP TO THE TOTAL US EQUITY MARKET (EQUITY ASSET CLASS)?

Just as benchmark overlap can affect portfolio return, so too can gaps in benchmark coverage. To achieve the most complete market representation and therefore, diversification, it is best if your benchmarks cover the entire market and add up to the total. The sum of your benchmarks should adequately capture the opportunity sets for stock market returns and allow you to properly evaluate the contribution of your investment managers.

A lack of understanding of the benchmark provider's methodology can result in "surprises" when assessing risk and return. Similarly, gaps and unrepresented segments of the market as well as unintended over or underweighting of sectors or styles can significantly affect your portfolio.

Questions to consider here include: Do your benchmarks cover all aspects of the market, even the smallest stocks? Are there other pieces of the market that your benchmark's missing—for example, are there medium-sized companies that aren't included in either your large-cap or small-cap benchmark? If your benchmarks don't sum to a representation of the overall market, you may be neglecting the performance of certain distinct segments of the market.

7 WHEN ASSIGNING SIZE/STYLE BENCHMARKS TO MY MONEY MANAGERS, DOES IT MATTER WHETHER I ADOPT BENCHMARKS FROM DIFFERENT INDEX PROVIDERS?

It is not uncommon to use benchmarks from different index providers. However, adopting consistently maintained benchmarks from a single index provider may increase your ability to reduce the effects of benchmark overlap, missing coverage, or other over- or under-weightings due to differences in methodologies.

Again, the point here about understanding the construction and maintenance of your selected benchmarks is important. Because the index providers differ on how they construct and maintain the indexes, using benchmarks from different providers will affect your Plan's assessment of Risk and Return.

8 IS IT A BIG DEAL TO CHANGE BENCHMARKS?

Innovations in indexing and advancements in technology occur all of the time. Therefore, the opportunity to utilize "new and improved" benchmarks/tools for assessing risk and return become available for consideration. Transitioning to a new benchmark(s) is not unusual and also not without consequence, though they may be small. It requires serious discussion with your consultant to determine the best process for adoption and implementation.



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