Multi-asset observations

The S&P 500 Index may not be the right benchmark for an investor

Foresters Financial

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Investors in financial markets often ask their advisors the question, "How am I doing". We think the question should be, "How am I doing compared to how I should be doing." This subtle difference is about shifting one's perception from absolute performance measurement to relative performance measurement. For instance, a child may *seem* to have only average math scores but relative to their peers may actually be above average. An investment portfolio may *appear* to be doing well (or poorly) but what it is being compared to is critical in determining how your fund manager is performing. Many investors' frame of reference for comparing their investment performance can be often misaligned and the process can be filled with psychological and emotional factors.

What is a benchmark?

Merriam Webster defines a benchmark as "something that serves as a standard by which others may be measured or judged; a point of reference from which measurements may be made". A benchmark is, hence, something that is pre-determined and should remain static over time (unless some material change occurs) so it can continually be the point of reference through a variety of scenarios. This consistency in application is a key element to a given portfolio's benchmark.

U.S. large-cap benchmarks are for U.S. large-cap investors

Today, one of the most widely recognized benchmarks in the world is the S&P 500 Index (S&P 500) but should it be the benchmark that most investors compare their portfolios against? Given the CFA Institute's criteria listed in *Exhibit 1*, a benchmark ought to be representative of an asset class. Therefore, if someone is investing in multiple asset classes (i.e., stocks, bonds, alternatives, etc.), it hardly seems suitable to adopt a single asset class index like the S&P 500. So why do some investors think of this index as the primary benchmark for their assets? Perhaps part of the reason lies in the media's coverage of financial markets. Simply turning on a business news channel will reveal that the S&P 500 and Dow Jones Industrial Average (DJIA) are commonly used performance references as they are easily understood, often seem to reflect the health of the U.S. economy and portray the overall profitability of large-cap, domestically oriented stocks. However, the S&P 500 Index is widely regarded as the best single gauge of *large-cap U.S. equities*.[1] In our opinion, this asset class distinction is critical for investors to understand as they travel along their investment journeys.

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Key highlights

- We think a portfolio's benchmark ought to be predetermined, remain static and be consistently applied.
- Attitudes toward benchmarks remind us of a convertible car—one for clear weather and another for the rainy season.
- Investors should understand that their portfolios often contain more than one asset class ... unlike the popular indexes shown on TV business programs.
- Investment expectations seem to leave many people unhappy but there is a solution.

Exhibit 1: What makes an effective benchmark?
According to the CFA Institute, benchmarks should be:

1. **Representative of the asset class or mandate**
2. **Investible**
3. **Constructed in a disciplined and objective manner**
4. **Formulated from publicly available information**
5. **Acceptable by the manager as the neutral position**
6. **Consistent with underlying investor status**

Source: CFA Institute.

[1] Source: S&P.

The delight of new cars

Selecting safety features on a new vehicle such as airbags or blind-spot warning indicators are important to some people, while other items, such as torque and rate of acceleration which may add a certain degree of risk to one's drive home, are important to others. But what all drivers ultimately care about is the overall profile of the car day to day—how it drives, how it looks parked in the driveway, how it handles in the snow. Similar to the specifics of selecting the car and its performance on the road, how an investor's asset allocation is split between defensive and risky asset classes will help determine the journey to their goals.

A change in weather

Things start to get interesting when roads become icy and treacherous. Driving home in these conditions, a driver cares mainly about the car's safety features and its handling. Once the weather clears, the driver is more likely concerned with speed and acceleration. This attention to the smaller parts of the bigger picture (safety vs. speed options) can cause us to lose sight of that wider perspective. This focus on the "now" is sometimes referred to as myopia by psychologists. This same mentality often applies to financial markets. When markets are rallying, we want the upside to our investments, but protecting our downside (i.e., safety) seems to matter far less. On the other, when trouble is brewing, we tend to want to minimize any losses.

Continuing with our car analogy, the speed limit is one constraint that stops a driver from endangering themselves (and others). However, a high speed limit can lull us into thinking that all is well until we hit an unseen pothole. The danger is present even though we obeyed the rules of the road. There are factors beyond the speed limit that the driver ought to consider. Analogous to financial markets, having the proper benchmark is often more important when the signals around us seem to imply everything is fine.

How does this relate to an investor's portfolio?

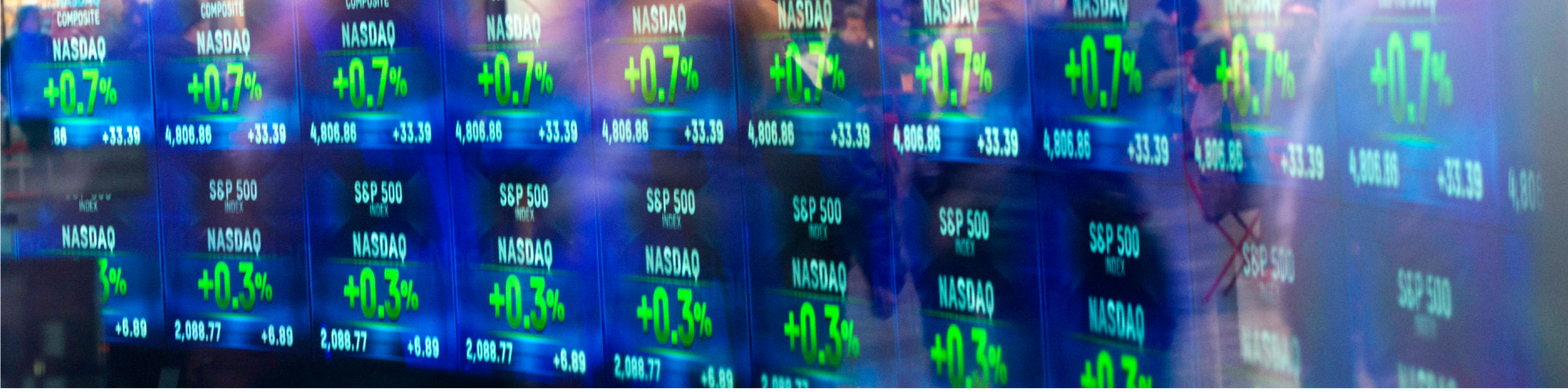
Consider a portfolio composed of 60% global equities (mixed equally between U.S. and international stocks) and 40% global bonds that meets an investor's objectives and constraints. In this base case scenario, stocks are expected to rise 10% and bonds to be flat (0%). Based on this scenario, shown in Scenario #1, *Exhibit 2*, the portfolio is likely to yield a 6% return based on its allocations [(60% x 10%) + (40% x 0%)]. The year goes by and stocks, in fact, rose by 12% and bonds were up 2%, with the portfolio returning 8% [(60% x 12%) + (40 x 2%)]. In this scenario, the portfolio outperformed its outlook by 2% [8% (actual return) – 6% (expected return)] but the investor, while no doubt happy about performance, may feel a tinge of regret that they hadn't invested in more equities. An outperformance of 200 basis points is an attractive return in today's climate, however, while this investor's relative performance to their initial expectations is strong, relative to global equities it is weak *(see Exhibit 2).*

Exhibit 2: Various scenarios under conditional benchmarking

		Hypothetical scenarios – expected total returns by asset class		
	Base case expectations	**Scenario #1** Equities outperform	**Scenario #2** U.S. equities outperform international equities	**Scenario #3** Equities drop
Global equities	10.0%	12.0%	5.0%	-10.0%
Global bonds	0.0%	2.0%	2.0%	4.0%
Cash	2.0%	2.0%	2.0%	2.0%
Expected portfolio return	6.0%	8.0%	3.8%	-4.4%
Excess return	0 bps	+200 bps	-220 bps	-1,040 bps
Theoretical happiness	😐	☺	☹	☹
Portfolio outcome		Beat 6% target	Missed 6% target	Missed 6% target
Realized (un)happiness		☹	☹☹	☹☹☹
Investor reaction		Didn't participate in equity rally	Underperformed greatly against U.S. equities	Lost principal
Investor's preferred benchmark	60/40	U.S. equities	U.S. equities	Cash

For illustrative purposes only. 😐= indifferent; ☺= happy; ☹= unhappy

Excess return is the investment return from a security or portfolio that exceed the riskless rate on a security generally perceived to be risk free, such as a certificate of deposit or a government-issued bond. Additionally, the concept of excess returns may also be applied to returns that exceed a particular benchmark, or index with a similar level of risk.



Home bias

Scenario #2 on the table shows the performance of U.S. equities relative to international equities if they were somewhat extreme, such that the U.S. is up 15% and international down 5%—a 20% performance spread. Based on a 50/50 split between domestic and offshore stocks, the equity basket returns 5%. How does our investor feel about this outcome? They did not make the 10% expected return on global equities but may be upset that they did not overallocate to the U.S. market. The emotional connection that the investor experiences, meaning what is now considered to be underperformance compared to U.S. equities, is exacerbated by that same business media we mentioned earlier. One need only take a quick peek at the home page of a popular business website to see how many points the Dow Jones Industrial Average was up (or down). This effect is amplified by the investor's familiarity with large-cap U.S. stocks and their products.

Worst case scenario—a loss of money

Now imagine a situation (see Scenario #3) in which global stocks fall 10% and global bonds return 4%. Here, an investor not only fails to meet their performance goal of 6% but also loses a portion of their principal. This investor's portfolio has both underperformed and lost money, making it the most painful of the three scenarios displayed in *Exhibit 2*. With such a result, the investor may well wish they were invested entirely in cash.

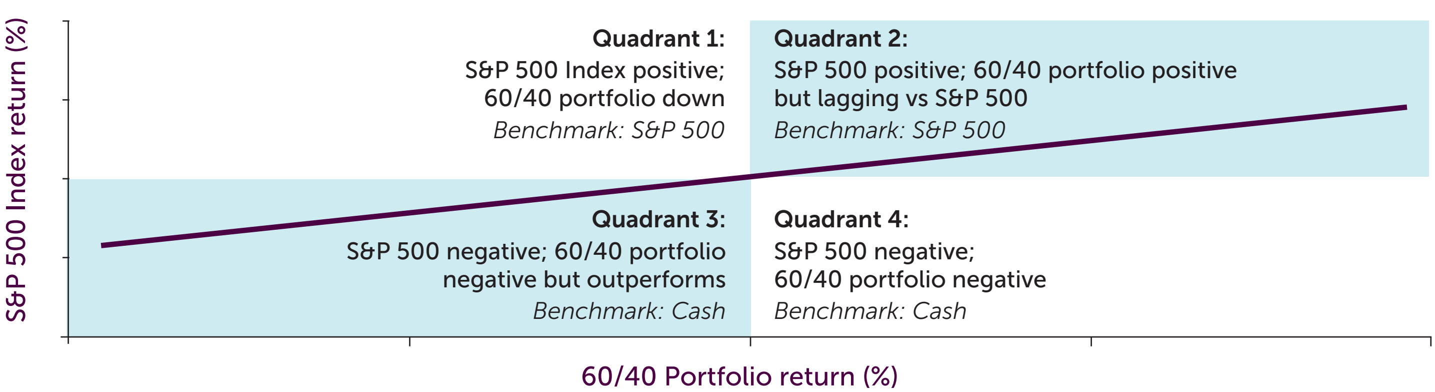
"Losses loom larger than gains"[2]

The challenge for many investors is that they think of benchmarks conditionally, meaning they have one benchmark for up markets and one for down markets. This leads us to two observations. First, the single reference point of stocks, i.e., the S&P 500, is not likely ideal for an investor who is allocated to multiple asset classes to diversify portfolio risk. Second, from our experience, pain seems to hurt more than pleasure helps. In economics, this is referred to as "loss aversion." It is commonly thought that the pain of losing is psychologically about twice as powerful as the pleasure of gaining. Thus, investors do not want to lose any of their principal—money for which they have worked hard. Hence, losses seem to loom larger than any gains that they might receive. This is probably a leading reason that investors often instinctually measure downside performance relative to zero or cash.

Why are we unhappy?

When equities are experiencing down markets and are below investor expectations, both the theoretical happiness and the realized happiness are negative (☹) as shown in *Exhibit 2*. But because the investor's return is negative (on an absolute basis), they are likely to feel even less happy than the feeling of lagging in a strong market rally. Recall our earlier definition that a benchmark should be used as a consistent frame of reference. Many investors seem to ignore this rule and want the best of both worlds—namely, to not lose any principal in down markets and also to keep up with popular stock indicators during equity rallies.

Exhibit 3: Hypothetical performance of 60% equity/40% fixed income portfolio vs S&P 500 Index



For illustrative purposes only.

[2] Kahneman, D., & Tversky, A.; 1979. "Prospect theory: An analysis of decision under risk". Econometrica, 47, 263-291.

These "one-sided" expectations, shown in *Exhibit 3*, set up the investor and their respective financial advisor for a certain level of frustration. Two examples may be helpful. Quadrant 2 illustrates an instance when the S&P 500 produces positive returns but an investor's traditional 60% equity/40% fixed income portfolio trails the large-cap index during the same period. Here, the investor assumes the S&P 500 applies to their overall portfolio, and overlooks their blended investment approach and accompanying benchmark. Quadrant 3 illustrates a market in which the S&P 500 has negative performance as well as the investor's portfolio; however, the latter actually outperforms the large-cap index (on a relative basis). In this instance, the investor intuitively shifts their preferred benchmark to cash. In both cases, the investor doesn't want to suffer any negative performance in either market. This becomes a case of wanting to have your cake and eat it too. We would suggest, under these circumstances, that there is a degree of inherent miscommunication between investors and their financial advisors.

So what is an investor's ideal benchmark?

The short answer is that there isn't an easy solution as each investor's goals and risk tolerances are unique. We think there needs to be a renewed emphasis on investor education regarding the applicability of portfolio benchmarks in a world of portfolio diversification. The value of a well-informed financial advisor in helping to navigate this journey and addressing an investor's specific investment requirements cannot be overstated.

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