WHAT YOU SHOULD KNOW ABOUT BENCHMARKING YOUR PORFOLIO’S PERFORMANCE

NEPC PRIVATE WEALTH

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Few investor concerns are as fundamental as portfolio performance. How to evaluate it is one of the most common questions posed by our private wealth clients. For NEPC, assessing performance takes into account the objectives–both financial and non-financial–that are unique to each family. But it all starts with evaluating investment decisions and their results. We call that process 'benchmarking' – gauging performance relative to an established benchmark.

Benchmarking is often viewed as a straight comparison of bottom-line numbers. But to truly evaluate your portfolio, it pays to drill down deeper. Like a sculptor, you've got to work the marble, using technique to match the finished product to your vision.

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We typically recommend that families focus on three aspects of performance:

- Evaluating the managers in your portfolio on a standalone basis
- Assessing how these managers work in concert to affect returns in key asset classes
- Calculating how the portfolio has performed relative to customized benchmarks

All three steps are needed for you to determine which decisions have been successful and which need improvement.

GATHERING YOUR MATERIALS: INDIVIDUAL MANAGER PERFORMANCE

Every manager needs their own benchmark – an investable market index that is relevant to their investment universe. These comparisons highlight strengths and weaknesses in your portfolio and help uncover which questions you should be asking.

The key to success in this step is to ensure you've chosen an appropriate index for comparison. For managers with a clearly defined style and strategy, the selection is typically straightforward. For example, managers focused on the broad, large-cap U.S. market might be compared with the S&P 500.

But the choice of benchmark must account for unique aspects of a manager's investment approach. For instance, managers with a more flexible style or those who invest across asset classes demand greater judgement as to which benchmark is likely to be most representative of the manager's portfolio.

Once the appropriate benchmarks have been determined for each manager in the portfolio, performance comparisons should be reviewed on a regular basis, but evaluated over a much longer timeframe.

Since all active managers will cycle through periods of outperformance and underperformance–based on the decisions they make and market dynamics beyond their control–our view is that we should evaluate managers over the course of a full market cycle (assuming there hasn't been a significant change, such as a change in mandate or the departure of a portfolio manager).

TAKING SHAPE: PERFORMANCE AT THE ASSET CLASS LEVEL

Manager results need to be aggregated before your portfolio can be evaluated. But NEPC doesn't recommend looking at the bottom line just yet. There's an important interim step – adding up how the managers within each asset class have performed as a group.

It's often at this stage that portfolio construction and personal vision come together. Asset allocation typically accounts for a larger share of portfolio return than individual manager decisions, so asset class data is critical to determining if you are on track to meet your goals.

Here again, choosing the right benchmark is important, and should reflect the nature of the portfolio. Clients who set broader allocation targets will typically use fewer, broad-based benchmarks. By contrast, clients who set narrower allocation targets will typically use more benchmarks, each with a narrower focus.

Aggregated asset class results should be compared to these market benchmarks regularly but, as noted above, we believe longer assessment periods are necessary to effectively evaluate the success of any program. This is particularly true if active management comprises a significant portion of the portfolio.

ADDING DETAIL: TOTAL PORTFOLIO PERFORMANCE

With these critical components in hand, you're in a better position to assess how your portfolio is doing relative to goals you've set and in the context of the broader market environment.

To facilitate this effort, we typically create a series of customized benchmarks appropriate to the specific portfolio. These additional yardsticks help refine your understanding of portfolio results.

- The policy index shows the return the portfolio would have earned if it were continuously rebalanced back to the strategic allocation and if all managers matched the return of their respective asset class policy benchmark.
- The allocation index shows the return the portfolio would have earned if all managers matched the return of their respective benchmarks. Unlike the policy benchmark, the composite benchmark is based upon the actual allocation, rather than the strategic allocation, of the portfolio.

THE FINISHING TOUCH: USING THE POLICY AND ALLOCATION INDEXES

These two custom indexes measure the total portfolio's performance in the context of the actual market environment. The allocation index is particularly helpful in identifying the impact manager selection has had on the portfolio.

- If the performance of the portfolio is greater than the allocation index, then the managers have collectively outperformed.
- If the performance of the portfolio lags the allocation index, then the managers have collectively underperformed.

The indexes also illustrate the impact deviations from the strategic allocation have had on the portfolio. These deviations are not uncommon; they could result from decisions at the macro level (for example, overweighting equities and underweighting bonds), or the micro level (for example, overweighting U.S. equities and underweighting non-U.S. equities).

The comparison between the total portfolio and the policy index illustrates the combined impact of both manager selection and deviations from the strategic allocation. The exercise of interpreting this data will differ for each client portfolio, but there are some commonalities:

- Clients with a larger allocation to active managers will typically see more dispersion between their total portfolio and the allocation index; clients with a larger allocation to passive managers will typically see less dispersion.
- Tracking error for passive managers can still be significant if the managers have a wide latitude to maximize tax loss harvesting or if their portfolio was funded with significant low basis holdings.
- Most private clients don't have significant dispersion between the policy index and the allocation index because turnover in those portfolios is relatively low. Private portfolios are usually taxable, and they will typically incur gains when making any significant changes to their asset allocation.

In some cases, it may be appropriate to include an additional benchmark for comparison with the total portfolio. For example, a family may have a trust with a 3% annual distribution and a desire to leave the next generation with an equivalent-sized portfolio in inflation-adjusted terms. In this case, a benchmark such as 'Inflation (CPI) plus 3%'" can be very useful in helping to know if the clients' ultimate goals are being met.

SUMMARY

We regard the portfolio performance measurement process as an invaluable tool to enable you to understand the strategic decisions that are made in your portfolios, and to help us fine-tune financial choices for your portfolios going forward.

Successful investing starts with laying out clear goals and, over time, making sure your investment portfolio's performance is on track to meet those goals through smart performance reviews. Investments that outperform their equivalent benchmarks add value for investors and can potentially become your fully realized 'masterpiece' investments.

DISCLAIMERS AND DISCLOSURES

- Past performance is no guarantee of future results.
- All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.
- The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.
- The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.

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