

Why benchmark selection is a form of client communication

By Quintin Rayer | June 21, 2018



Many advisers use collective investment funds for their clients' investment needs. In many cases, these are managed relative to some stated benchmark index, although others may have "cash-plus" or absolute return targets. Equally client portfolios may be measured against indices (or composite indices) adjudged to represent their investment needs and risk profile.

This article explores some requirements for the selection of suitable benchmark indices and outlines how advisers can be on the alert for some fund management practice where published benchmarks can be misleading to investors.

Introduction

Many funds or portfolios are managed relative to a benchmark index. However, benchmarks are often used somewhat simplistically or even inappropriately, making this an area where advisers can add value for their clients by delving a little deeper.

All too often, benchmarks are used only to see whether the fund has kept up with, or beaten, the selected index in terms of its returns, with little thought given to the

choice of the index used. Alternatively, funds are often ranked in quartile terms within their peer group, running risks that peer constituents are not fair comparators and again focusing on returns.

For meaningful performance analysis, the risk dimension should also be considered. Ideally, a fund should generate superior risk-adjusted returns, i.e. either higher returns for the same level of risk, similar returns for less risk, or preferably achieve both higher returns and a lower level of risk. In other words, the fund should have a higher return-per-unit-risk than its benchmark index. Although, as mentioned in previous articles [1], [2], the definition of 'risk' can be elusive, so that different definitions can be used.

What does a 'Good' benchmark look like?

For fund performance evaluation, the characteristics of an appropriate benchmark index would include the following [3]:

- » The index should be targeted, well maintained and unambiguous.
- » It should be suitable to the fund preferences (e.g., a UK blue chip portfolio might use the FTSE 100 index).
- » It should be appropriate to the currency of the portfolio.
- » In some instances the index should be investable, i.e., composed of investments that can be held in the portfolio.
- » It has to be easily measurable so that its return can be calculated as frequently as needed and not include illiquid securities that are hard to 'mark to the market'.
- » It should be representative of achievable performance, i.e., it has a weighted composition reflecting market capitalisation.
- » Ideally, the benchmark should separate out the relevant components of performance, i.e., total return indices for total return, as well as capital appreciation/loss.

Benchmarks as Client Communication

The choice of benchmark index presented on promotional materials to clients and advisers is an aspect of communication between fund managers and their clients. Regrettably, at times, this can be prone to manipulation, with managers changing published benchmarks to flatter their performance or to mask deteriorating returns. Advisers can support their clients by careful examination of index choices.

A benchmark index should indicate the 'opportunity set' the manager uses, i.e. the universe the manager selects their particular investment holdings from. Thus for a large-cap US equity fund, an appropriate benchmark might be the S&P500, with the implication that individual investments would comprise companies listed in the S&P500 index. Although it may be acceptable for a few stocks to be selected from

elsewhere, significant investment outside this universe would be unexpected. In any case, the manager should make clear the degree to which they invest away from their benchmark, to avoid the danger of misleading their investors.

An example of unsatisfactory benchmark index selection might include a UK mid-cap equity fund which draws stocks from the FTSE250 index, but the fact sheet shows a FTSE350 benchmark (which is a combination of the FTSE100 index and the FTSE250).

In this case, mid-cap equities would be benchmarked against a combination of large and mid-cap stocks. This means that when mid-caps outperform large-caps (as there can be a tendency to do), the fund may look as though it has beaten its benchmark, when in reality it may have performed in-line with its mid-cap opportunity set (represented by the FTSE250). Further, the FTSE100 comprises 83% of the FTSE350 by market cap, compared with 17% for FTSE250 firms [4]. Thus benchmarking against the FTSE350 uses an index that is dominated by FTSE100 companies.

From these comments, it becomes apparent that selecting a particular index as a benchmark is actually an act of communication between a fund manager and their clients.

Better Benchmarks

When a fund manager states that a particular index is being used as a benchmark on fund literature, their client investors should reasonably be able to expect that:

- » The index is representative of the investment activities of the fund.
- » The significant majority of individual investments made will be drawn from constituents of this index, with exceptions indicated and the degree to which off-index investments can be made clearly stated.
- » The future index returns would be representative of the level of future returns they can expect.
- » The index risk level is representative of the risk level they can expect.
- » The degree to which routine active or passive management would be expected to generate performance deviations from the aggregate index performance should be stated (e.g. tracking error, beta range).
- » Any significant departures from the above should be clearly and transparently communicated.

How this helps Advisers

Fund managers have been prone, at times, to 'game' benchmarks used, with their benchmark index selection to flatter their performance, and not to meet the conditions above. Consequently, this is an area where advisers can add value for their clients by ensuring their due diligence includes checking that appropriate benchmarks

References

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