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Stock indices important for gauging portfolio performance

ON INVESTING
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Several years ago, I worked with an investment adviser who did not like to show investment performance to his clients. In fact, he never even calculated returns for his managed accounts. He really had no idea or interest in how he was performing, and certainly did not want his clients questioning him about their returns.

One day he mentioned to me that his performance over the years had been strong. I asked how he knew, and explained that since he never looked at returns, there was no way he could know if they were strong. Annoyed, he responded "well, no one has ever complained."

Unfortunately, that is the way a lot of the investment industry approaches performance. Investment professionals often prefer not to discuss their results, perhaps because it is so difficult to generate strong performance. No one wants to be challenged about the value they create for their clients.

However, it is important for investors to understand how well they are being served, and whether they are getting value for the fees they are paying. They should therefore demand to be shown periodic returns.

However, even investors who do know how well they have performed often fail to put their returns into the proper context. For example, assume you earned a return of 10 percent. Would you be happy with that? It seems like a solid return. However, what if you later learned that your neighbor earned 11 percent over the same period? Most people would be less happy. They might even be downright angry if they found out that "the market" earned 14 percent. The return remains the same, but the reference point can make a big difference in how we view the success of that return.

Accordingly, seeing account performance is not enough. Investors should also demand that their returns are shown in comparison to robust, appropriate benchmark indices.

A benchmark is just a yardstick of sorts that helps you compare your performance. Typically, a benchmark is a stock or bond market index that has similar characteristics to those of your portfolio.

The Dow Jones Industrial Average, the Standard & Poor's 500, and the Russell 2000 are all indices that are commonly used as benchmarks in the investment industry. However, there are literally hundreds, if not thousands, of indices that can be used as tools to assess investment returns.

There are good indices and bad, and some that are designed for research purposes that may be less meaningful in the real world. From a practical standpoint for individual investors, I believe a solid benchmark index should be broad-based, represent an appropriate measure of an asset class, have a consistent methodology, and should be investable.

A broad-based index is one that includes a lot of investments from its asset class. Consider domestic large-cap stocks. The Dow Jones Industrial Average is often quoted as a measure of large-cap stock returns, but it only includes 30 stocks. The S&P 500 measures the same asset class, but includes 500 stocks. Clearly, the S&P would be a better gauge of how the broad-based large-cap stock market has performed.

Next, a good benchmark index should be an appropriate measure of its asset class. This seems logical, but often there are unintended exposures in indices. We just discussed the S&P 500 being a domestic, large-cap stock index, but it also has a number of mid-cap and small-cap stocks as members. The large-cap stocks tend to dominate the performance of the index, but any drift away from the pure asset class could skew performance over time.

A consistent methodology is important so you know you are making a fair comparison through time. An example here is the inclusion of China's A-shares in the MSCI EAFE Emerging Markets index. Stocks listed on China's Shanghai and Shenzhen exchanges have not historically been included in the index, but it is likely they will be added shortly. This will significantly alter the risk and return characteristics of the index in the future versus its past returns. As the world of investments evolves, some changes are inevitable, and desirable. However, you want to be aware of these changes and how they impact the performance of your benchmark so you aren't drawing the wrong conclusions about your performance.

Finally, an index should be investable. That is, an investor ought to be able to purchase all of the constituents of the index. The S&P 500 consists of large, liquid stocks that could easily all be purchased. However, the Bloomberg Barclays Aggregate Bond Index, the bellwether for domestic bond market performance, would be almost impossible to replicate. There are a number of illiquid bond positions included that hardly ever trade. Also, the index includes thousands of bond issues, further impairing the ability to fully replicate the index.

That said, there may not be a perfect index. Russell does a good job of building broad, representative, transparent indices. Though, from a practical perspective that sometimes hurts them. The Russell 2000 is the industry-standard benchmark for small-cap stocks. However, because the construction of the Russell 2000 is so transparent, a number of traders and hedge funds trade ahead of the annual index reconstitution, which drives up the prices of stocks entering the index and drives down the prices of stocks exiting the index. This results in lower performance for the index. Looking back over the past ten years, this has resulted in 1.5 percent less performance annually than a small-cap stock index from S&P.

This is one of the gimmicks the investment management industry uses to make its performance look better than it might actually be. Using easy-to-beat indices, changing benchmarks opportunistically over time, and cherry-picking time periods can all result in favorable performance comparisons. Investors should be aware of these tricks and insist on robust benchmarking that is consistent through time.

While there may be no single index that is a perfect benchmark for your specific portfolio, several indices can be combined to give a clear performance benchmark. A balanced portfolio may need to be measured by a weighted average of separate stock and bond indices. And, within stocks, separate large-cap, mid-cap, small-cap, and international indices may be required for a true "apples-to-apples" comparison. A little math may be required, but without proper benchmarking, you may be paying too much for subpar performance.

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