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Why benchmarks matter

November 2019

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Summary

Benchmark[1] selection is an important part of the investment process. Even benchmarks that look similar can be quite different, and those differences can have a significant effect on portfolio performance over the long term. Choosing a benchmark index that differs from your policy index can introduce tracking error and should be done with care. There are tools available to help investors choose their benchmark indexes, and to identify tracking error introduced though benchmark mismatch.

Introduction

Investors have a wide ranging and complex task when they are building portfolios. They likely have some idea of the investment goal they need to achieve, which may even be expressed in risk and return terms. To meet that goal, however, they turn to the capital markets and are suddenly presented with the tyranny of near-infinite choice. How should they categorize the asset classes that are available to them? What tools should they use to forecast the likely behavior of those asset classes? What should they use to describe the mandates they give to investment managers, and to measure the success or failure of those investment managers?

The answer, of course, is that they choose a series of indexes, likely one for each asset class. These indexes from that moment ***are*** in a real sense those asset classes for the investor: the performance of the indexes will be used to describe the performance of those asset classes, the characteristics of those indexes will be assumed to be the characteristics of the asset classes, and the difference between the managers selected and those indexes will be described as "tracking error". They will be analyzed in detail, with little time spent on understanding whether this difference is being caused by the behavior of the manager, or is instead being caused by some unusual behavior of the index caused by the way that index is built rather than actual market movements.

In other words, the choice of the indexes the investor intends to use is an important one. Despite this, many investors spend little to no time on this choice. In this paper we will show that even the small differences between similar benchmarks can be important, that these small differences can matter over time, and that similar benchmarks can have quite different exposures within them.

Benchmark choice is never going to be the single most important decision that investors will make, but benchmark choice will deeply affect how every investment decision that the investor makes is later evaluated. Spending time on this decision once every few years seems to be an appropriate use of resources, and to be something worth spending time on.

Similar benchmarks are still different

The first point we need to address is the fact that even benchmarks which seem quite similar can, in fact, differ enough for the choice between them to matter. We can see this in a comparison below between a set of different, but standard, indexes - all of which might be rational choices to use as benchmarks for their respective asset class.

We compare three indexes here: the **S&P 500**, which is very widely used indeed; **MSCI USA**, which is much less used by domestic U.S. investors unless as part of a global portfolio, but which is designed for a similar purpose; and the **Russell 1000.** The differences in methodology between these are relatively minor. The return and risk differentials through time are small, but can be meaningful, especially when put into the context that active manager tracking error relative to one of these benchmarks will often be measured in tens of basis points.

		1 Year	3 Years	5 Years	7 Years	10 Years	15 Years
S&P 500	**Annualized Return**	4.25%	13.39%	10.84%	13.26%	13.24%	9.01%
MSCI USA	**Annualized Return**	4.14%	13.29%	10.73%	13.20%	13.22%	9.09%
Russell 1000	**Annualized Return**	3.27%	12.54%	9.98%	12.55%	12.56%	8.52%

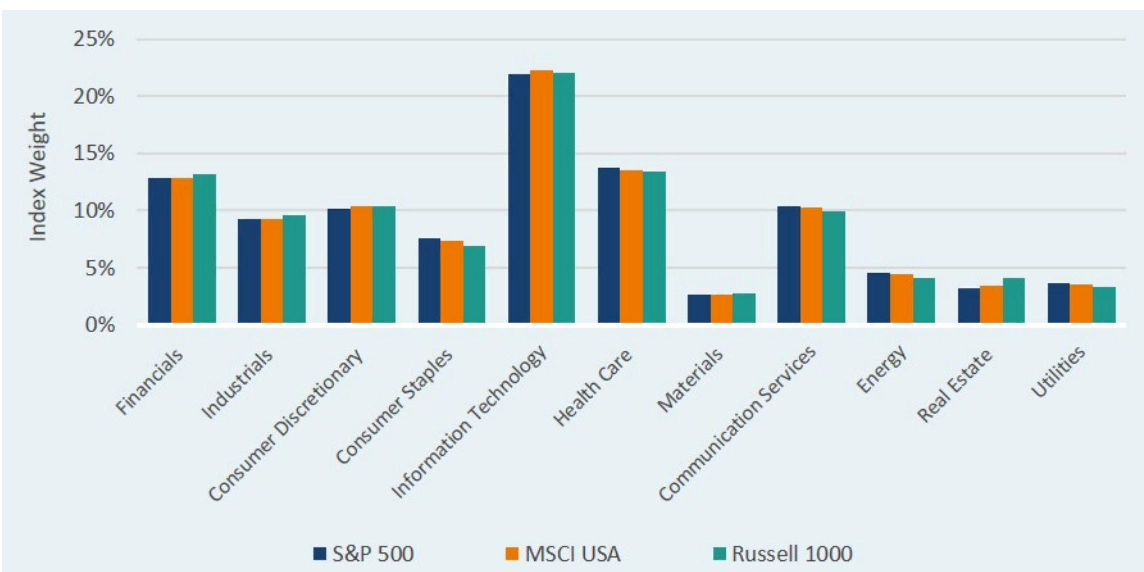
		1 Year	3 Years	5 Years	7 Years	10 Years	15 Years
S&P 500	**Annualized Risk**	18.75%	12.18%	11.93%	11.10%	12.55%	13.81%
MSCI USA	**Annualized Risk**	18.88%	12.22%	11.98%	11.15%	12.62%	13.86%
Russell 1000	**Annualized Risk**	19.10%	12.32%	12.01%	11.20%	12.74%	14.06%

While some of these indexes are more widely used or popular than others, the reality is that they are all viable approaches to measuring the markets concerned – with such big differences we should not assume that the most popular index is necessarily most appropriate. The differences in outcomes reflect real differences in content. Choosing which of these indexes to use as a benchmark should not be a simple assumption, but should take into account the accuracy with which the benchmark truly reflects the underlying market as well as the degree to which it is currently used in the investment management landscape.

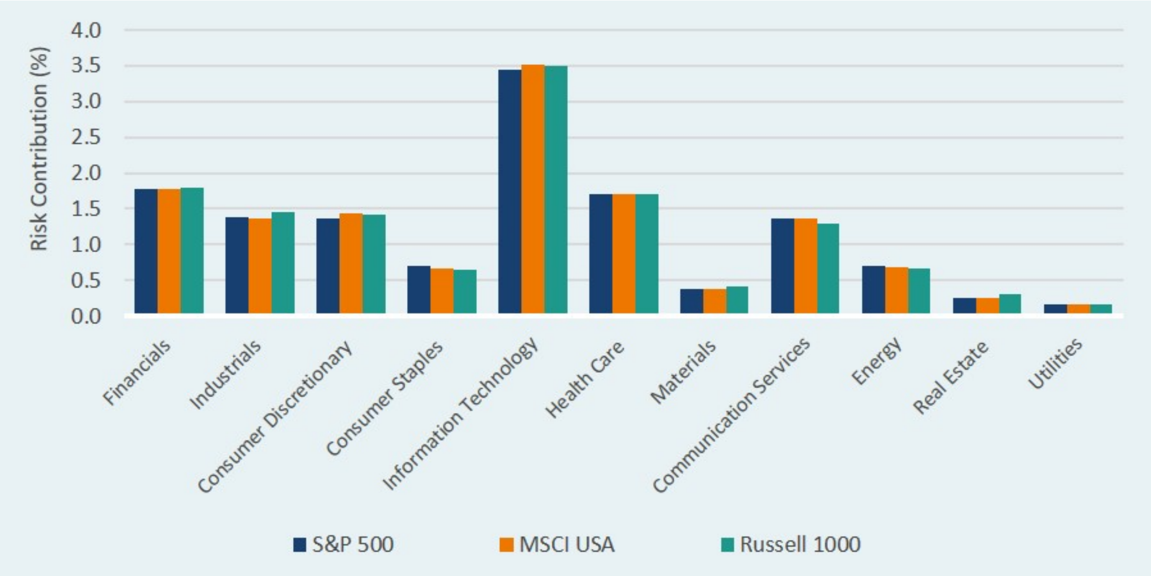
Benchmark differences in exposure

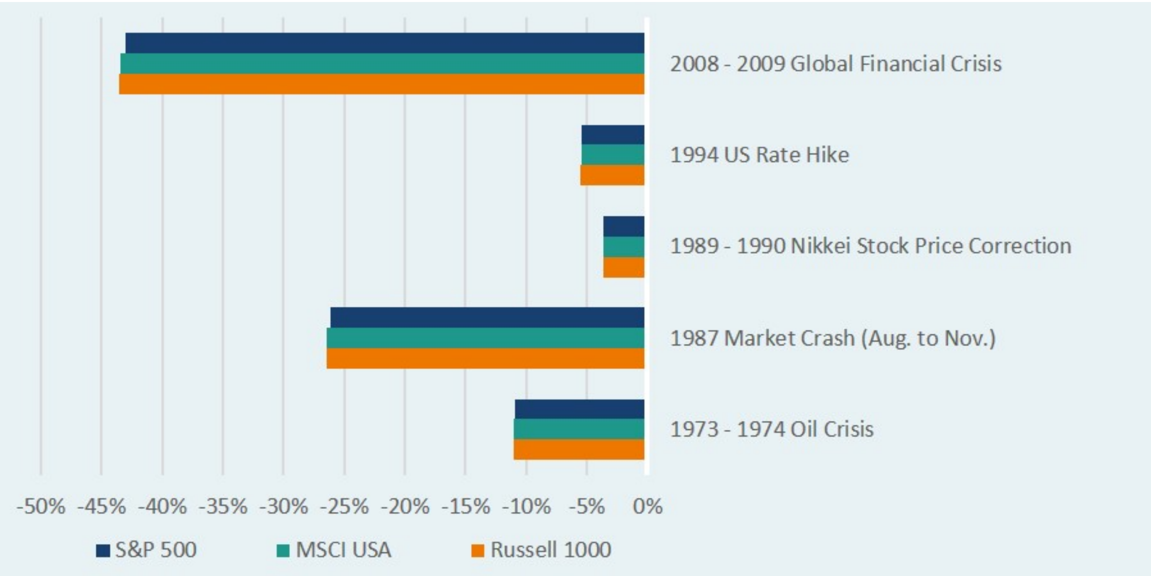
Similarities between benchmarks can often hide shorter term risk exposure differences too. These can matter, both because they may explain some of the longer-term return differences, but also because they can result in shorter-term differential risk sensitivity. We can see these differences in exposures when we use standard risk analytical tools to assess the differences between indexes.

Below we examine these U.S. benchmarks through a risk exposure lens. While some benchmarks are currently more popular than others there is not necessarily reason to believe that exposure differences are anything other than accidental. We are able to compare benchmarks across differences in sector, size, and industry weightings. Again, we can see differences – some small, but some meaningful, depending on the asset class in question.



Second, we look at these same index pairs using Barra. This allows us to look at the impact on these indexes from a variety of different market environments and shocks. The result remains similar – while the benchmarks do move in similar ways (we are, after all, still measuring equity markets, so most of the behavior will simply be the equity behavior), most differences are not insignificant. This is certainly true when compared to differences that might be introduced by a single active manager being hired.





Choosing benchmarks - conclusions

The conclusion of this paper is simple. In each market there will be available a variety of different indexes. Each benchmark might be reasonable for the investor to choose for their portfolio. The investor should not simply default into the most popular index when making that benchmark choice, but instead should think a little more about the nature of the indexes they are considering, and the consequences for their portfolios. Availability of products in the market is an important metric, but there are a range of other metrics which should be considered. In particular, the index should be constructed in a way which is specified in advance, appropriate, measurable, unambiguous, reflective of current investment opinions, accountable and investible. Spending a small amount of time going through this process once every few years can help investors more effectively understand how they are describing the markets in which they invest, and can help them ensure that they avoid accidental risk or exposure bets that they do not intend.

Notes & Disclosures

1. *In this paper we are talking about benchmarks and indexes. It's important to be clear about the distinction. Indexes are a special type of portfolio, that is not actively managed and that describe a systematic part of a market or sub-market. Benchmarks are a special type of index, which are chosen to represent an asset class or sub-asset class and which are used to mandate and measure managers.*

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