Wespath
Investment Management

The white papers and thought leadership articles published prior to 2019 were created under the Wespath Investment Management brand name. Upon the January 2019 launch of Wespath Institutional Investments, the Wespath Investment Management brand name was discontinued.

Did Your Asset Manager Choose an Appropriate Benchmark?

Choosing an appropriate benchmark is essential for providing investors a baseline for evaluating an asset manager's success over the long-term. An inappropriate benchmark can make a skilled manager look ineffective or an underperforming manager look capable. However, choosing the right benchmark is subjective and not always straight-forward—it requires careful consideration between the asset owner and investment manager.

This paper presents Wespath Investment Management's (Wespath) approach for benchmark selection. Wespath believes that investors should not allow investment managers to select narrow benchmarks against which they favorably compare when those benchmarks do not accurately reflect their investable security universe or investment strategy.

While an inappropriate benchmark may offer the appearance of higher benchmark-relative returns for the investor, it may also expose the investor to higher-than-expected risk. We believe appropriate benchmarks should reflect the strategy and style of the investor's portfolio, taking into account acceptable risk and desired return.

Characteristics of Performance Benchmarks

Generally, a benchmark should be:

- **Transparent**—the names and weights of individual investments are clearly known
- **Investable**—investors have the option to forgo active management and passively approximate the benchmark
- **Measurable**—the performance can be calculated on a frequent basis
- **Appropriate**—investment style is consistent with the portfolio being measured
- **Specified in advance**—the benchmark is selected prior to the beginning of an evaluation period
- **Understandable**—investors (and participants) should readily understand the benchmark and its components
- **Public**—investors (and participants) should be able to verify performance using third-party data

(continued)

Benchmark Characteristics
Transparent
Investable
Measurable
Appropriate
Specified in advance
Understandable
Public

"Wespath's chosen benchmarks may be more difficult to outperform; however, they are intended to be a better measure of the risks we are taking and the returns we are hoping to achieve."

These benchmark characteristics are desirable because a performance benchmark ideally should serve two purposes:

1) **Backward-looking**—as a yardstick to measure the success of an investment strategy. By using a publicly published index, or a blend of such indices, investors can confirm and evaluate for themselves the benchmark's performance. Toward this goal, the assets held in the benchmark should be priced regularly to ensure that benchmark performance is measurable, and historical data should be available. If the benchmark is investable, meaning someone could invest in a benchmark-replicating passively managed portfolio, then the performance benefit of an active investment strategy can be measured through time.
2) **Forward-looking**—as a basis for investors' risk and return expectations. A benchmark that is transparent, appropriate, understandable and specified in advance will enable investors to evaluate the potential future performance of the benchmarked investment strategy. Changes to the benchmark constituents should be reasonably low to allow investors to form reliable expectations. Also, any change to the benchmark investment strategy should be communicated with enough notice that investors can adjust their return expectations in a timely manner.

Selecting a Too-Narrow Benchmark

Typically, investment managers will select the benchmark against which prospective investors will evaluate their performance. Some managers choose a narrow benchmark for evaluation purposes—even though they may invest in a broader group of securities than the benchmark includes.

Beating the S&P 500

Let us compare two broad-based U.S. Equity indices—the S&P 500 Index and the Russell 3000 Index—to understand how some investment managers invest more broadly than implied by their benchmark selection.

The S&P 500, widely regarded as the most recognizable benchmark representing the U.S. equities market, includes the common stock of 500 leading companies in the U.S. The index focuses on the large company segment of the market and covers about 78% of the value of all U.S. equities, making it a proxy for the total market.

In contrast, the Russell 3000 is a broad-market index that measures the performance of the 3,000 largest U.S. companies based on total market value, so it includes small and medium-sized companies. Some experts consider the Russell 3000 a better representation of the U.S. stock market because it contains six times as many stocks as the S&P 500, and covers about 98% of the value of all U.S. equities.

The following table reports returns for the two indices for several periods ending June 30, 2016. Notice that the 20-year returns of the Russell 3000 surpassed those of the S&P 500, but the Russell 3000 underperformed by at least 50 basis points annually for the one-, three- and five-year periods. The combination of benchmark and time period selections for performance comparison can have a significant impact on relative results.

As of 6/30/2016	Annualized Rate of Return				
	1 YR	3 YR	5 YR	10 YR	20 YR
S&P 500	3.99%	11.66%	12.10%	7.42%	7.87%
Russell 3000	2.14%	11.13%	11.60%	7.40%	7.96%

Source: FactSet

To evaluate the prevalence of investment managers investing more broadly than implied by their benchmarks, Wespath analyzed data from investment management firms that provide holdings and performance information to Wilshire Associates, a leading investment consulting firm. Wespath focused on large-cap managers that are likely to use the S&P 500 as their performance benchmark.

We evaluated the extent to which these managers invest in companies outside of the large-cap index. Of the 100 managers we analyzed, the median investment manager held more than 20% of its portfolio in small- and mid-sized companies, which comprise approximately two-thirds of the securities of the Russell 3000. Including smaller companies in a portfolio could cause portfolio performance to significantly differ from the performance of the S&P 500, depending on the time period evaluated. We believe the Russell 3000 is more appropriate for such investment strategies.

> “Appropriate benchmarks should reflect the strategy and style of the investor’s portfolio, taking into account acceptable risk and desired return.”

International Markets Perspective

In the U.S., the MSCI EAFE (Europe, Australasia, and Far East) Index of more than 900 companies is widely accepted as the standard benchmark in measuring international equity performance. It comprises 21 MSCI country indexes, representing the large- and mid-size companies of 21 developed markets outside the U.S. and Canada. However, a broader global equity benchmark, such as the MSCI All Country World Investable Market Index (ACWI IMI), is designed to measure the equity market performance of all developed and emerging markets. The MSCI ACWI IMI covers more than 8,500 securities across large-, mid- and small-cap segments and across style and sector segments in 46 developed and emerging markets.

The performance figures in the table below indicate that the broader MSCI ACWI IMI Index provided significantly higher returns than the narrower EAFE Index over the time periods measured. If the investment manager’s strategy includes securities that are beyond the scope of the MSCI EAFE, then the broader MSCI ACWI IMI may be a more appropriate benchmark.

As of 6/30/2016	Annualized Rate of Return				
	1 YR	3 YR	5 YR	10 YR	20 YR
MSCI EAFE	-10.16%	2.06%	1.68%	1.58%	3.96%
MSCI ACWI IMI	-3.87%	6.13%	5.43%	4.48%	5.68%

Source: FactSet

The Fixed Income Rationale

The Barclays U.S. Aggregate Index is the most widely recognized fixed income index and covers the U.S. investment-grade, fixed-rate bond market including government and corporate securities, mortgage pass-through securities and asset-backed securities.

In contrast, the Barclays U.S. Universal Bond Index is a broader index that includes all the bonds in the Barclays U.S. Aggregate Index, as well as riskier fixed-income securities, such as high-yield bonds and U.S. dollar-denominated emerging-market debt. As the table below indicates, adding riskier asset classes can provide opportunities for enhanced returns compared to the narrower Barclays U.S. Aggregate Index. If an investment manager takes advantage of these enhanced return opportunities, the broader Universal index should be used.

As of 6/30/2016	Annualized Rate of Return				
	1 YR	3 YR	5 YR	10 YR	20 YR
Barclays U.S. Aggregate	6.00%	4.06%	3.76%	5.13%	5.67%
Barclays U.S. Universal	5.82%	4.20%	4.01%	5.30%	5.84%

Source: FactSet

Observe the performance differential between these two indices in the 20-year column. Some institutional investors might assume that 17 basis points per year over a 20-year investment period is not much of a difference. However, this difference is meaningful for fixed income managers—some of whom target 50 basis points of outperformance relative to an index.

Blending Indices

Some investment strategies are difficult to benchmark due to their unique objective or specialized approach. Wespath’s Inflation Protection Fund (IPF) is a good example. IPF seeks to provide investors with current income and protect principal from loss of purchasing power due to inflation. The Fund holds a combination of U.S. and non-U.S. inflation-linked fixed income securities, commodity futures contracts, floating rate senior secured loans and other investments. No published index captures the unique characteristics of IPF, so Wespath periodically re-evaluates the appropriateness of available indices, as well as the possibility of blending indices, to implement an optimal IPF benchmark.

Conclusion

When assessing the success of an investment manager’s performance, it is important to consider whether the investment manager has chosen an appropriate performance benchmark. The dilemma seems to be: should managers select an ‘easy- to-outperform’ benchmark that makes their performance appear successful or should they select a benchmark that accurately represents the asset manager’s investment strategy—even though it may be more challenging to demonstrate success?

As an institutional investor, Wespath selects benchmarks that most closely match our investment strategy for a particular asset class and the breadth of securities held in a portfolio. In our view, an appropriate benchmark should reflect the strategy and style of the portfolio, taking into account acceptable risk and desired return. Wespath's chosen benchmarks may be more difficult to outperform; however, they are intended to be a better measure of the risks we are taking and the returns we are hoping to achieve. They also are fairer measures of how well we are performing.

Sources:
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Note: This paper was originally published in 2011 and updated in October 2016.

About Wespath Investment Management:
Wespath Investment Management (Wespath) is the investments division of Wespath Benefits and Investments, a general agency of The United Methodist Church. Wespath provides investment solutions for the endowment and pension (defined contribution and defined benefit) portfolios of institutional investors, including foundations, higher education institutions, health care organizations, and churches through a broadly diversified family of daily-priced funds. Wespath's investment process proactively incorporates environmental, social, and governance (ESG) factors through active ownership practices (engagement and proxy voting) and investments in market-rate community development loans. As of September 30, 2016, total assets under management were in excess of $21 billion.

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