CLEARPOINT

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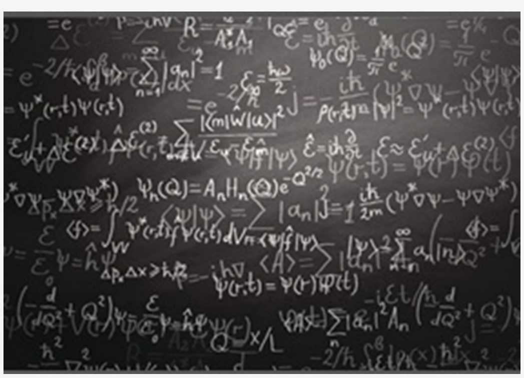
MAY 2021

LAWRENCE M. CARONE, CFA, CAIA, MANAGING DIRECTOR

HOW ORGANIZATIONS SHOULD BENCHMARK THEIR INVESTMENT RETURNS

BY LAWRENCE M. CARONE, CFA, CAIA, MANAGING DIRECTOR



"Clearly, *relative* performance has been great!"

What exactly does that mean? Relative to what? Was it actually good performance? Did my investment advisor add value? Did we meet our financial objective or not?

That last question—did we meet our financial objective—is important and should be asked when assessing an investment program. A portfolio's return can look

CLEARSTEAD CONTINUES TO BOLSTER TEAM WITH NEW TALENT

We are pleased to announce that we have added talent to the Private Client and Administration teams with Max Zarick and Dan Usay, respectively.

Max Zarick joined Clearstead as a Client Planning Associate. Max comes to us from Novogradac & Co. where he was a Sr. Accountant, Audit & Tax. He recently received his CPA designation and has a Master of Accountancy degree from Cleveland State University.

Dan Usay joined Clearstead as a Business Analyst. Dan will be responsible for working with all departments to optimize processes, analyze datasets, and create reports that provide insights on operations, productivity, and profitability. Dan previously worked at Equity Trust for seven years as a Sr. Business Analyst, Tax and has a Bachelor of Business Administration, Economics degree from Kent State University.

These changes underscore the firm's commitment to building its investment consulting practice, promoting the next generation of leadership, and maintaining a rigorous investment process.

great on many measures, but if the returns have not met the organization's financial objective, what is the point? Further, if returns met the financial objective, was it through the skill of the advisor or luck? What other factors do we need to measure?

There are several ways to benchmark portfolio returns, ranging from simple to more complex, and each measures something different. Below, we will assess benchmarking a portfolio to measure the following:

1. Did we meet our financial objective?
2. Did we get strategic allocation right?
3. Did we select the right managers?
4. Did we have the appropriate amount of risk?
5. Did we outperform our peers?

DID WE MEET OUR FINANCIAL OBJECTIVE?

As mentioned earlier, this question is most important and should be asked by every organization to assess the success of its investment program. At Clearstead, we believe the biggest risk in investing is not meeting an organization's financial objectives. This can mean a college having to raise tuition, a museum reducing its hours or offerings, a hospital needing to increase debt—significant potential problems tied to portfolio underperformance. Many E&F investors have a straight-forward objective—to meet current spending needs and maintain the real purchasing power of the fund over time. There are many different ways to express this objective and many different spending rules, but most simply, this objective is expressed as follows:

Annual Distribution Rate as a Percentage of Portfolio Value + The Rate of Inflation = Return Objective

For example, for the past ten years a hypothetical foundation, LMC Foundation, had an annual distribution rate of 5% and annual inflation was 1.7%.[1] The LMC Foundation's past ten-year return objective is 5.0% +1.7% = **6.7%**.

The calculations become more complex if the endowment is using a multi-year average of market value to determine spending or other constraints on the spending rule. Articulating and explicitly comparing a portfolio's actual return with this objective is crucial, and should be assessed over a period long enough to cover at least one market cycle and smooth inflation over time.

Other benchmarks such as market indices or peer group comparisons are important but mean little if the primary objective of an endowment or foundation—to meet spending needs and build the portfolio at a rate above inflation—is not met. For LMC Foundation above, a ten-year return below 6.7% means it is depleting its assets; above 6.7% means it is meeting its obligations.

DID WE GET STRATEGIC ASSET ALLOCATION RIGHT?

Now, let us assume that ten years ago, the investment committee of LMC decided that the strategic allocation should be 60% stocks and 40% bonds. Once that was determined, an appropriate strategic benchmark (a policy portfolio benchmark) was created to match the strategic allocation (in this case, a long-term static benchmark consisting of 60% in the S&P 500 index and 40% in the Bloomberg Barclays Aggregate Bond Index). Let's further assume that over the ten-year time-period, the LMC portfolio returned 9.5% and the policy benchmark returned 9.3%.

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Most important, the LMC portfolio exceeded its primary objective. It also exceeded its policy benchmark return. At least on these comparisons, the portfolio did well.

Yet perhaps we should be asking more questions. Yes, our investment advisor determined an asset allocation that exceeded our return objective, but could we have done better? Did the advisor make good tactical decisions? Did they select the right managers? Was the level of risk appropriate? Was it luck or skill? How did we compare to peer organizations?

The following sections cover some of these questions.

DID THE PORTFOLIO GENERATE ENOUGH RETURNS TO BEAT THE STRATEGIC BENCHMARK?

The LMC Foundation met the return objective but let us drill down to see how else the advisor added or detracted value. What if the return deviated from 9.3%? If it was:

BENCHMARK RETURN	WHAT DOES THIS TELL US?
Less than 9.3%	Tactical and/or manager selection decisions *detracted* value
Equal to 9.3%	Tactical and/or manager selection decisions *neither added nor detracted* value
Greater than 9.3%	Tactical and/or manager selection decisions *added* value

Tactical decisions are made to overweight or underweight asset classes relative to the strategic benchmark. Examples of tactical decisions are: “Equities are overvalued, so let’s have an overweight to bonds and an underweight to stocks” or “Let’s have a disciplined rebalancing strategy and rebalance to targets when asset class weightings cross a certain threshold.” If the LMC Foundation had invested in all passive strategies in the 60/40 portfolio and rebalanced back to the 60/40 target daily, the returns would have matched the benchmark. If the Foundation made the tactical decision to have an overweight in either asset class, any deviation would come from those tactical decisions.

In the scenario where the portfolio was rebalanced daily to the 60/40 allocation and active managers were used for either asset class, any deviation from the 9.3% could be reflective of overall manager selection decisions.

If both tactical decisions and active managers were used, we would need to look at return attribution.

Return attribution will show sources of return relative to the strategic benchmark. Were relative returns driven by tactical asset allocation decisions or were returns driven by manager selection or a combination of both?

DID WE SELECT THE RIGHT MANAGERS?

Manager selection is the easiest benchmark to read on a performance report. Did the manager in a particular asset class outperform its stated benchmark? If we hired an investment grade core bond manager, did it beat the bond Index?

Measuring manager performance against stated benchmarks is a pretty simple way to judge an underlying investment manager, but when assessing the overall performance of an underlying investment manager, the same questions covered in this article apply.

When Clearstead’s research analysts analyze a manager’s historical returns, we look for consistency of outperformance over rolling time periods. We also examine returns relative to the amount of risk taken with a variety of measures: tracking error, information ratio, Sharpe ratio, Sortino ratio, r-squared, beta, semivariance, VAR, liquidity, or hundreds of other risk measures.

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DID WE ACHIEVE OUR RETURNS WITH THE APPROPRIATE AMOUNT OF RISK?

One important measure of risk is volatility of returns or the variability in returns year to year. In our example, the LMC Foundation had an annualized return of 9.3% over the last ten years. If the portfolio returned 9.3% for each one-year period for ten straight years, then the variability or standard deviation of returns would be zero. The Foundation's 60/40 strategic benchmark, however, had a standard deviation of returns of 8.5%, which means that 66% of the annual returns fell between 0.8% and 17.8%. One third or 33% of returns fell outside of that range.

The table below shows the LMC Foundation portfolio's realized volatility as measured by standard deviation:

STANDARD DEVIATION OF RETURNS	WHAT DOES THIS TELL US?
Less than 8.5%	The portfolio had *less* risk than the strategic benchmark
Equal to 8.5%	The portfolio had *the same* risk as the strategic benchmark
Greater than 8.5%	The portfolio had *more* risk than the strategic benchmark

You may be asking yourself, "If we hit our return objective, who cares about volatility?" However, volatility matters to the LMC Foundation. E&F's have annual spending requirements to help support operations and grant-making. Lower volatility helps keep the amount available to spend predictable when budgeting for grants. There are two primary ways to smooth spending over time. One is to calculate the spend from a rolling average of the portfolio market value (see our July 2019 *ClearPoint* article). The second is to design a portfolio to meet an E&F's return objective while keeping the volatility level of annual returns to a minimum. In investment speak, this is called mean variance optimization.

Comparing volatility experienced by the portfolio with volatility of the strategic benchmark helps organizations understand if the portfolio took more or less risk than the benchmark to achieve its goals.

HOW DO MY RETURNS COMPARE TO MY PEERS?

Next, you may say to yourself, "Great, our portfolio exceeded its return objective, beat its strategic benchmark, all the underlying managers outperformed their benchmark, and we experienced less volatility than the strategic benchmark. This is all fantastic. However, how did we compare to everyone else in our industry?"

Portfolio returns and risk measures can be compared relative to a group of peers of similar size and similar return objectives. Reporting systems, such as Clearstead's, track returns for all of Clearstead's clients as well as other investment advisors' clients. The reporting system then categorizes each by segment—Endowments and Foundations, Healthcare, Defined Benefit Pensions—and by size of assets. Actual portfolio returns and strategic benchmark returns are ranked for various time periods. If the LMC Foundation portfolio's 10-year return of 9.3% ranked in the 22nd percentile, that means that the return was higher than 78% of the Foundation's peers. Risk measures can be ranked over different time periods as well.

Peer group rankings are another way to measure the success of your organization's investment program. Ranking well among an organization's peers sends a powerful message to your organization's donors.

WHICH OF THESE BENCHMARKS SHOULD ORGANIZATIONS FOCUS ON?

Organizations should consider all these benchmarks. Consultants and investment committee members are all guilty of opening quarterly reports and looking at top line performance relative to a strategic benchmark. While this return is important, it does not tell the whole story. The full story comes from answering the questions posed at the beginning of this article.

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Sources:

(1) U.S. Bureau of Labor Statistics Consumer Price Index, 10-year as of 3/31/21.

MARKET BENCHMARK RETURNS

April 30, 2021		1M	3M	12M	YTD
US Large Cap	S&P 500	5.3%	13.0%	46.0%	11.8%
US Small Cap	Russell 2000	2.1%	9.6%	74.9%	15.1%
Developed Intl	MSCI EAFE	3.0%	7.7%	39.9%	6.6%
Emerging Intl	MSCI Em Mkt	2.5%	1.7%	48.7%	4.8%
Real Estate	NAREIT	7.9%	17.2%	35.5%	17.0%
Core Fixed	BarCap Agg	0.8%	-1.9%	-0.3%	-2.6%
Short Fixed	BarCap 1-3Yr	0.1%	0.0%	1.0%	0.0%
Long Fixed	BarCap LT G/C	2.0%	-5.9%	-4.4%	-8.7%
Corp Debt	BarCap Corp	1.1%	-2.3%	4.2%	-3.4%

Source: Bloomberg

The performance data shown represents past performance. Past performance is not indicative of future results. Current performance data may be lower or higher than the performance data presented.