

## HOW AND WHEN TO USE A BENCHMARK

### What purpose do benchmarks serve?

**RI Inches:** Benchmarks can help provide institutions with a framework for achieving successful long-term investment results. Once risk and return objectives have been codified, a system to measure progress will be needed. Thoughtfully selected benchmarks are helpful for understanding portfolio performance over time and are additive to an institution's portfolio construction process.

### Can benchmarks serve as a useful tool in monitoring portfolio risk?

**RI:** Absolutely. While risk management should focus on the risk of permanent loss of capital, portfolio drawdown, and correlation of investments, too often investors focus on the risk of underperforming a benchmark, leading to unintended outcomes. The risk metrics underlying a benchmark are always changing. Institutions need to factor these changes into their decisions to manage their risk allocation.

### How does one choose an appropriate benchmark?

**RI:** The primary objective and responsibility of an institution's asset manager is to construct and manage a portfolio that meets or exceeds its return and risk objectives. The measurement of success should be performed over a prescribed, long-term time frame against an appropriate benchmark(s), as defined in the institution's investment policy statement (IPS). Defining an absolute benchmark (net of inflation), typically derived from a combination of an institution's annual spending/draw requirement and its risk (maximum drawdown) tolerance, and a relative benchmark derived from the strategic asset allocation targets set forth in the IPS can be very effective.

### What should one be aware of when considering benchmarking investment progress?

**RI:** Read the small print. The investment management industry is masterful at presenting performance numbers in the most favorable way. Institutions need to understand why a benchmark was chosen and whether it provides a fair comparison. Typically, performance reporting includes footnotes which provide important information. Always take a moment to read the footnotes and understand what they mean.

### How should one think about periods of outperformance and underperformance?

**RI:** It is rare that institutions will consistently outperform a benchmark. When periods of underperformance do arise, a clear understanding of why can lead to better long-term decisions. Patient investors typically benefit from the compounding of returns in a well-constructed portfolio.

### Can benchmarks help generate alpha?

**RI:** Alpha generation (excess return over the benchmark) is the value added by great managers. Alpha exists for a discerning investor with patience and access. Proper understanding of comparative benchmarks can help investors identify managers who have developed a process for generating alpha.

### What does it mean to be benchmark agnostic?

**RI:** Benchmark agnostic is a compelling concept. It supports the notion that benchmarks are often overused and underscores the need for good investing.

### When should one avoid using a benchmark?

**RI:** There are many instances where benchmarks can lead to poor decisions. For example, investors will often chase the "hot manager", when it is a bull market they are chasing. Sometimes identifying the great manager experiencing a period of underperformance is the better approach.



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