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How to establish and apply an appropriate portfolio benchmark

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The creation of a portfolio benchmark comparison is crucial, whether it's for a high-net-worth or institutional investor. Choosing an inappropriate benchmark can lead to harmful inaction or decisions that can be detrimental to the portfolio.

An investor's allocation should be determined by an asset-allocation study that reflects their objectives. Objectives should include time horizon, liquidity, taxes, volatility, downside risk and return expectation.

Various strategies (such as U.S. and non-U.S. equities, and different market capitalizations; fixed income investment; real estate and other alternatives such as hedge funds, private equity and commodities) should be considered to meet those investor expectations.

After the portfolio is designed, the benchmark comparison should be built to accurately measure success in terms of both return and risk.

One portfolio's benchmark comparison -- the client's goal -- was to a custom index comprised of 50 percent S&P 500 and 50 percent Lehman Brothers Aggregate Bond Index. The investment committee felt comfortable with performance, although it was slightly behind the benchmark comparison.

The problem was, however, that the portfolio was allocated much differently than the custom benchmark. Only 60 percent of the portfolio's equity allocation was in large-cap stocks, which the S&P 500 represents, with the remaining allocated to small stocks and international equities.

In the last few years, the allocation to small and international stocks added value to the portfolio, as they significantly outperformed large stocks. Consequently, it was easy for the portfolio to beat the S&P 500.

A more appropriate benchmark for that portfolio's equity allocation should have been 30 percent S&P 500, 15 percent MSCI EAFE (international equities) and 5 percent Russell 2000 (small stocks). When the portfolio was compared to this allocation, its performance was even worse than originally thought.

The benchmark always should reflect the universe of securities from which the manager(s) is selecting. If a manager's universe is very broad, the index should be broad, representing the market that they're investing. If the universe is narrow, such as the S&P 500 Value index, the benchmark should be equally narrow.

For multimanager portfolios, the combination of the appropriate indexes should be built.

The bottom line is that having a focus on proper portfolio benchmarking not only can help an investor understand how their performance stacks up to an unmanaged index, but can be helpful in taking appropriate action.

Investors, whether high-net-worth or institutional, must recognize that it may not be in the interest of the manager/advisor to appropriately benchmark their performance. Managers have unique approaches to put their firm, product and performance in the best light.

We've had four straight years of great markets, and it's easy to ignore proper analysis. The problem is that when the market turns (and it will), it may be too late.

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