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Investment Basics

Benchmarks: Selecting a Benchmark

With the vast number of benchmarks to choose from, deciding which one, or which combination of indexes, to use as a benchmark can be difficult. (For more basics on benchmarks, please see Understanding Benchmarks.) But this decision is critically important for several reasons.

First, portfolio risk and return will be heavily influenced by the benchmark. When portfolio managers construct a portfolio, they typically take the securities in the benchmark as a starting point from which to take active positions in an effort to add value.

Second, the benchmark indicates not only the kinds of securities that should be included in the portfolio, but also the types of securities that should not be in the portfolio. For example, choosing a government bond index as the benchmark for a fixed income portfolio is a strong indicator its holdings should not include many securities with a high degree of risk. Choosing a small cap stock index, such as the Russell 2000, means an investor is not seeking exposure to the large companies in the Dow Jones Industrial Average.

Third, some benchmarks are better suited to specific investment goals than others. For an investor whose primary goal is capital preservation, an important criterion for a bond index might be credit quality. If the portfolio is intended to offset liabilities that change with interest rates, the most important consideration when selecting a benchmark might be the benchmark's interest rate sensitivity (or duration), rather than its prospective returns.

Selecting the right benchmark can be particularly important for investors looking to invest in international securities. Because foreign currency exposure can affect the value and the volatility of a portfolio, global securities can serve two distinctly different purposes, depending on whether the foreign currency exposure is hedged or unhedged.

A global investor who wants to take a position on currency by investing in foreign holdings would use an unhedged index – one that is exposed to changes in currency values. For example, an investor who believes that the U.S. dollar will weaken may choose to invest in securities denominated in other currencies because they will increase in value if the dollar falls. However, investors seeking capital preservation or to meet liabilities typically opt for indexes that hedge currency risk and avoid the volatility that currency investing can bring.

The Main Considerations in Benchmark Selection

Given the importance of selecting the right benchmark, here are some key questions to answer before making a choice.

What are your overall performance goals, and what is your tolerance for volatility, or risk?

Investors should evaluate their return goals and risk tolerance before selecting an index. An investor with a low risk tolerance will most likely select an index with a shorter duration or higher credit quality. An investor looking for a high return may select an index with a track record of high long-term returns, which might also exhibit performance volatility and carry the chance of negative absolute returns over shorter time periods.

Investors seeking to meet long-term liabilities with their investments should consider not only the pattern of cash flows associated with their liabilities but also the risk factors that can cause changes in liabilities. For example, liability-driven investors who choose to invest in fixed income could work with an asset manager to create a custom benchmark composed of a combination of government bonds, index-linked bonds, swaps and corporate bonds that closely matches the risk factors of the liabilities. Such a custom index could potentially provide a better fit than existing indexes while also providing flexibility to adapt to changes in the liability stream over time.

What is your need for liquidity?

An investor looking to invest operating cash that is used to meet short-term liabilities or obligations will need a highly liquid portfolio and would most likely select an index with a very short duration. This type of investor would want to stay away from riskier benchmarks that contain less liquid securities and exhibit greater interest rate sensitivity. Cash investors may also select custom benchmarks designed to match their liquidity profiles.

Do you have liabilities that are linked to inflation?

Rising levels of inflation can erode the real, or inflation-adjusted, returns on an investment. A fixed income investor with inflation-linked liabilities might therefore choose, for example, the Barclays Capital Euro Inflation-Linked Index, made up of Euro zone inflation-linked bonds whose principal and interest payments rise with inflation. Indexes tracking the performance of specific investments that tend to benefit from inflation, such as real estate and commodities, can serve as benchmarks for portfolios invested in these assets, including the Dow Jones U.S. Select Real Estate Trust (REIT) Index and the Dow Jones-UBS Commodity Index.

How many different types of securities do you want your portfolio manager to be able to invest in?

A benchmark should be a "good fit" for your portfolio and your investment manager in terms of the range of securities in which it can invest. A broad investment universe can help increase return potential and reduce volatility. If the benchmark is "too narrow," however, it may be difficult for the investment manager to make noticeable contributions to the portfolio's overall performance through active management.

What Makes a Good Benchmark?

Selecting a specific benchmark is an individual decision, but there are some minimum standards that any benchmark under consideration should meet. To be effective, a benchmark should meet most, if not all, of the following criteria:

Unambiguous and transparent – The names and weights of securities that constitute a benchmark should be clearly defined.

Investable – The benchmark should contain securities that an investor can purchase in the market or easily replicate.

Priced daily – The benchmark's return should be calculated regularly.

Availability of historical data – Past returns of the benchmark should be available in order to gauge historical returns.

Low turnover – There should not be high turnover in the securities in the index because it can be difficult to base portfolio allocation on an index whose makeup is constantly changing.

Specified in advance – The benchmark should be constructed prior to the start of evaluation.

Published risk characteristics – The benchmark provider should regularly publish detailed risk metrics of the benchmark so the investment manager can compare the actively managed portfolio risks with the passive benchmark risks.

With benchmarks today covering all types of assets and investment strategies, it makes sense to choose carefully and only after deciding one's investment goals and risk tolerance.

A word about risk: An investor should carefully consider the underlying risks contained in an index and their risk tolerance when evaluating an index. All investments contain risk and may lose value. It is not possible to invest directly in an unmanaged index.

Duration is the measure of a bond's price sensitivity to interest rates and is expressed in years.

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