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What Your Manager Won't Tell You about Investment Benchmarks

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It's time for your quarterly meeting with your company's investment manager. It probably follows one of the following scripts:

Scenario 1: The manager has apparently beaten the benchmark.

The manager starts with a brief macroeconomic review, including typical comments about the Fed, spreads, and market trends. He/she spends some time highlighting your portfolio, and then emphasizes how your portfolio is doing terrifically well, easily beating the benchmark. The meeting ends with all shaking hands, and hoping for a similar performance next quarter.

Scenario 2: The manager has apparently not beaten the benchmark.

The manager starts with a very long macroeconomic review, showing how events largely outside of his/her control have caused temporary, unexpected market dislocations. He/she spends some time highlighting your portfolio, and then quickly shows that your portfolio did not beat the benchmark. However, you are told not to worry because either: (1) this was a very unusual quarter, and/or (2) the benchmark you use really isn't very relevant to your company's portfolio (it has so many Treasuries that would give you low yields that just wouldn't give you the income you need). The meeting ends with all shaking hands, and hoping for a return to "normalcy" and better performance next quarter.

You were probably treated to both scenarios last year. Scenario 1 probably applies to the results of the first, second and fourth quarter of 1998, while scenario 2 dovetails nicely with the 'flight to quality' seen in the third quarter of 1998.

No, we are not psychic, but we do know that, for many insurers, it is too easy to abdicate the difficult job of developing and following an appropriate investment benchmark to its investment manager. Though this is akin to letting the wolf watch the hen house, the business of the insurer is, after all, insurance, and investing is best left to the experts.

However, as a prominent investor in insurance companies once said: A company that doesn't focus on both sides of the balance sheet is asking for trouble—either through sub par investment results and profitability or hidden investment problems.

One of the best way to judge how your investment portfolio is performing is by comparing it to a relevant benchmark—after taxes and after fees.

AIMR Performance Presentation Standards recommend using after tax performance calculations for taxable clients. In essence, this means that accrued interest and dividends are tax affected by the company's highest effective marginal tax rate. Realized gains and losses are tax affected, while unrealized losses and gains are not tax affected. AIMR's logic here is clear. Unrealized gains and losses on a securities portfolio may never be realized. This is especially true for fixed income securities that may never be sold, just allowed to mature. Thus, tax affecting unrealized gains and losses is not allowed by the AIMR standards.

But how do you know if the benchmark is appropriate? This is fairly well spelled out in the literature for CFAs, where six basic characteristics are outlined.

The chart below outlines those six characteristics and applies them to companies that use a truly customized benchmark (TCB), a generic index (e.g. Shearson/Lehman Aggregate Index), and a mix of different generic indices. A TCB is a group of randomly selected fixed income securities with the duration, credit and asset category characteristics required by the insurer's asset allocation strategy. TCBs and other performance measurement issues are discussed in more detail at the SAAInteractive.com web site (*http://www.saai.com/performa1.htm*).

You probably use some kind of generic benchmark(s), or some slicing and dicing of those benchmark(s).

Characteristic	TCB	Generic	Generic Mix
Specified before investing begins	Yes	Yes	Yes
Understandable construction	Yes, specific securities are all known	Not really, specific securities are not known	Not really, specific securities are not known
Investable	Yes	Impossible, benchmark size is too large	Impossible, benchmark size is too large
Measurable and possible to track	Yes	Yes	Yes
Relevant, tied to the insurer's strategy	Yes	No	Only if mix is related to product strategies and capitalization
Realistic constraints (e.g. maximum loss)	Yes	No constraints	No constraints

But, did you know:

1. Generic benchmarks may include securities that are not allowed in your investment policy. For example, the popular Shearson/ Lehman Aggregate Index (SLAG) includes Yankee bonds—non-U.S. issuers in US$. Does your policy allow investment in foreign securities?

2. Generic benchmarks include more U.S. government bonds than you would ever want in your portfolio. Of course, too high an allocation to US government bonds is not desirable for yield reasons. Here's a chart showing the approximate asset allocation found in commonly used indices.

	Shearson/Lehman Aggregate Index	Shearson/Lehman Govt/Corp Index
Sector	%	%
Government	48	73
Corporate	21	27
Mortgage-Backed	30	0
Asset-Backed	1	0

3. Generic benchmarks should not be used as both return and yield bogeys. The yield for a generic benchmark is a simple weighted average of the yields of the underlying securities. Remember that yields need to be calculated in a non-linear fashion, not as a linear weighted average. An article in the *Journal of Financial Analysts*[1] has shown that this has produced up to 90 basis points in error.

"The benchmark you choose should be the right one for your company's liability and capitalization, despite 'unusual' market conditions."

4. Managers that want to use multiple benchmarks for a single portfolio are probably good at smoke and mirrors. The more benchmarks the merrier for the manager, since it gives him/her an added chance to beat something. Your benchmark should incorporate yield and return requirements, but it should be one benchmark.

5. The strategic asset allocation decision you make will provide 80%+ of the returns of your port folio. This has been shown in classic articles in the *Journal of Financial Analysts*[2]. Therefore, if you make this decision internally, your manager can only really provide value at the margin. Thus, it is very important to have an accurate, appropriate benchmark against which to measure performance.

6. The benchmark you choose should be the right one for your company's liability and capitalization, despite "unusual" market conditions (see Scenario 2 above).

With this information, you are now properly prepared for the next quarterly meeting with your investment manager. However, please be prepared for the most obvious howling about using a more appropriate benchmark: "It's too much work to use a truly customized benchmark!" To which the best reply may be, "It's too dangerous not to use the proper benchmark. We want to be involved in accurately managing both sides of the balance sheet, thank you."

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Bibliography

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