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# THE. PERFECT. BENCHMARK.

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## Purpose

Benchmarking is a way of life. Babies are benchmarked to national averages and assigned percentiles for height and weight. Children are graded and sorted based on the academic standards they meet relative to peers. Teenagers compete to exceed a highly complex and mostly unknown admission's benchmark of a coveted university. And for many adults, annual job reviews benchmark one's performance against peers and goals as they compete for more rewarding careers. There is no shortage of benchmarks, they are embedded in our lives.

Your investment portfolio is no different. If you have an investment advisor, they provide you with portfolio, benchmark and peer group returns one, two, four, even twelve times a year. Is this healthy? Not necessarily. Does focusing on short-term results lead to better investment outcomes? Not often. Should we reset our expectations and approach our performance reports with a different mindset? Yes, but it is hard and requires some re-wiring. There is a hierarchy of benchmarks, and we often lose sight of the one at the peak of the pyramid – goal accomplishment.

## It Can Be Risky To Your Health.

Just as spending to keep up with the Joneses can bankrupt an otherwise financially healthy family, reacting to relative performance month in and month out can put an otherwise on-track portfolio into a tailspin. Note, index-only investors have little to worry about here, they have resigned themselves to accepting below benchmark returns. This paper addresses investors who use active managers or a mix of active and passive managers.

Loss aversion is preferring to avoid losses rather than acquiring equivalent gains. Daniel Kahneman and Amos Tversky were credited for this theory in 1979, with Kahneman eventually winning a Nobel Prize in 2002 for their work in applying psychological insights to economic theory. They are the fathers of a powerful field of study - behavioral finance. Some of their work has shown that losses are twice as powerful, psychologically, as gains. Losing to a benchmark can have up to double the impact of winning versus a benchmark by the same amount. Why do we share this discovery? Because, at some points in time, all active managers underperform. Because great active managers sometimes underperform their benchmarks significantly. Obsessing over monthly returns can make you wonder why your portfolio has so many "losers" strewn about. Well, what about when they win? It is easy to forget about winning because bouts of losing hurt so badly. Do you see where this is headed?

## Batter Up.

Investment analysts sometimes cringe when they hear the term "batting average". A batting average is the number of times a manager outperforms its benchmark over a number of equal-length time periods. Professionals know that it must be handled with caution since it is such a simple metric. It ignores the magnitudes of wins and losses as well as the risk taken to achieve those results. If my batting average is 40%, but I outperformed by huge margins and only underperformed by tiny margins, my batting average will not reflect my success. This scenario rarely happens over long periods of time, so the simplicity of a batting average outweighs its shortcomings for our purposes.

We have long held the belief that a 30-day performance comparison is random, half the time you win, half you do not. In fact, we would argue that a 90-day, 1-year, and even 3-year return streams are closer to random than not. Skill is not determined over one 3-year sample. We know that, but we often see scoring systems that heavily weight recent performance to "boil it down" to a single number that is actionable. Portfolio management does not work that way – believing it does can cause a false sense of confidence.

In order to test our "even the greats have random short term performance" hypothesis, we pulled a Morningstar universe of active managers as of September 30, 2020, filtered out the more esoteric categories and focused on stock and bond managers in traditional style boxes, such as large cap value or small cap growth1. That list was sorted, high to low, on investment manager 15-year performance. US growth stock managers (small and large) were the 15-year winners with returns in the high teens to low twenties. We then carved off the top twenty managers – the best performing managers in the best performing asset classes and calculated their batting averages.

**Créme de la Créme Results**

**15 - Year: Monthly Batting Average : 56%**

**15 - Year: Quarterly Batting Average : 60%**

Impressive? Hardly. Yet, these managers compiled, on average, a more than 3.5% excess return over their prospectus benchmark annually for 15 years! To put a dollar value on that, a $1 mm investment in the average of the 20 "best" funds 15 years ago would have yielded $675,000 more in your portfolio today than its benchmark. That is a tremendous long-term track record built on what some might perceive as mediocre short-term performance.

## Can You Handle It?

If a manager wins 60% of the time, it loses the other 40%. Can you handle disappointment 40% of the time? It is not easy. We all know that monthly performance begets quarterly, annually, and so on.

Imagine three months of losing to a benchmark, then seeing that the manager also missed its benchmark for the quarter. By definition, this has to be true, but guess what? That is four punches that hurt twice as much as when your manager outperforms each month. Remember loss aversion? Might you question why you are paying active management fees for underperformance? Maybe not outright, but a seed of doubt has probably been planted that next month's result can only start to change. Psychologically, it can be hard to handle. It is possible to judge the outcomes of your portfolio too often. It is human nature to get manager fatigue from a return stream that is no different from a great manager, simply by measuring them too often. And our sample is the top 1-3% managers in their peer groups, A 60% batting average is the best you are going to get. Imagine what a 25th percentile manager looks like.

## What To Do Then?

Upon realizing that humans are programmed to fail, we ask ourselves, what can I do? We propose three methods of overcoming our weakness.

1. Index a portion of the portfolio. Indexation costs are rock bottom, and you will never be greatly surprised by the outcome – always a few basis points below benchmark. Even when other parts of your portfolio are lagging, you always have a fund that holds a bit of everything. Passive management is also a great choice for efficient areas of the market. While not exciting cocktail chatter, using some passive is probably a wise decision for many investors.

2. Dive deep into long term, shallow into short. Short term numbers have very little meaning whereas long term performance, statistical measures, and portfolio characteristics do. Are portfolio characteristics consistent relative to peers over long periods of time? Has a strategy performed as expected during volatile markets? If portfolio management duties transitioned, did the portfolio strategy change?

3. Be patient and have faith in the investment process. Knee jerk reactions to short term blips are normal but can be combatted. Your investment consultant is part market wizard but also more psychologist than you may think. Making portfolio adjustments that seem uncomfortable at the time usually means they are doing something right. And remember, just like a money manager there will be wrong decisions. Nobody can perfectly predict the future and even if they could, investing in it would remain difficult.

Looking at the 12 months leading into our current recession, the growth story of the past decade continued. Growth stocks outperformed with returns of 36% relative to 26% for value stocks. These favorable returns would peg growth and value as the 2nd and 3rd highest returns, respectively, relative to all recessions that have occurred in the past fifty years.

## The Perfect Benchmark Is...

Humans love to benchmark. Afterall, we have been engaged in benchmarking since birth. We would never recommend abandoning benchmarks and leaving your portfolio unmonitored. A proper portfolio is managed to your risk and return profile with an eye towards long-term goals. We need benchmarks and a healthy dose of perspective to measure our portfolios and make sure we remain on track. They help investors see trends and course correct, when necessary.

However, we would argue that the perfect benchmark has no stocks or bonds in it at all. Instead, the perfect benchmark is whether your financial assets achieve the goal for which they are intended. Are you able to comfortably retire? Is your foundation able to effectively support the mission of your organization? Can grandchildren emerge from college without a heavy debt burden? Will an endowment enrich the lives of many for decades to come? Are you properly invested to meet the needs of today and the goals of tomorrow? These are the benchmarks, the real life portfolio impacts, that we strive to realize over the course of a portfolio's life.

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## Employee Higlight

Ryan has worked with Cornerstone since 2002 and is a Principal of the Company.

Upon completion of his Master's degree, Ryan began his career at Cornerstone as an Analyst. He is responsible for portfolio design, reporting and research, and data analysis. He is a member of the Investment Policy Committee which makes decisions on investment-related research and due diligence. As a member of the Lead Team, Ryan plays a major role in the day-to-day operations of the business.

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