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Benchmarking Institutional Investment Portfolio Performance

| Stan Miranda |

In order to measure the success of the portfolio and the effectiveness of the team managing the overall institutional portfolio, it is important to clearly establish and agree the benchmarks against which the portfolio's performance will be measured over the short and long term. We believe that a well-executed multi-asset class portfolio can generate between two and three percent of annual outperformance versus a simple portfolio of equities and bonds with a similar overall risk level, due to the benefits of diversification across asset classes, tactical shifts in asset class exposures and asset manager outperformance. None of these sources of excess returns can be expected in every year but should be realised through a full investment cycle.

We believe that any investor, but institutional investors in particular, should evaluate long-term performance net of all fees and expenses relative to a benchmark with equivalent risk to that of the portfolio. The appropriate benchmark against which the portfolio's performance should be compared depends on the time horizon. Over the long term, comparison to the portfolio's target return and a risk equivalent reference index of equities and bonds is appropriate. Over shorter time periods, the portfolio should be compared to a composite strategic asset allocation ("SAA") benchmark (an index of asset class indices that reflect how the portfolio is invested).

Long Term Return Target: Over a rolling 5-year time horizon, the portfolio's performance is measured against the absolute Long Term Return Target (measured in client currency). The return target will typically be a real return that is sufficient to meet the spend obligations of the portfolio. The Long-Term Return Target = Long Term Real Return Requirement (informed by the portfolio's spending rule) + Long Term Inflation Assumption + Margin of Safety to meet required return / scope for real capital appreciation.

Equity Bond Reference Index: Over a rolling 5-year time horizon, the outsourced CIO's portfolio performance should be measured against a reference index constructed solely of equities and bonds in a mix that replicates the target risk level of the portfolio. For example, a portfolio targeting an equity risk level of 70% would be benchmarked against an equity and bond index consisting of 70% equities and 30% government bonds. Broad asset class indices (e.g. MSCI World for equities) are used to proxy the performance of equities and bonds. This index is the most basic representation of a multi-asset class portfolio. Differentials between the outsourced CIO's performance and this benchmark index are due to the diversification benefits of a fully multi-asset class portfolio, tactical asset allocation and manager selection.

SAA Composite Benchmark: The SAA Composite Benchmark is calculated using the performance of representative asset class indices weighted by the target allocation to that asset class in the portfolio's long-term target allocation. Differentials between the outsourced CIO's performance and this benchmark are due to tactical asset allocation (i.e., allocation skews away from the Strategic Asset Allocation) and manager selection (i.e., whether the managers within which the portfolio is invested within each asset class outperformed the passive alternative). In every investment committee meeting, the outsourced CIO should provide a performance attribution of the portfolio relative to this benchmark, highlighting the contribution from manager selection and tactical asset allocation, broken out separately. This can be compared to the outsourced CIO's fees, allowing analysis of the "return on fees" for the investment in the outsourced CIO. We would recommend aiming to generate a ratio of 3x the outsourced CIO's fees in outperformance.

Peer Group Benchmark: Institutional investors include endowments, foundations, pension funds, insurance portfolios, sovereign wealth funds and family offices. Clients we have in each of these categories generally want to compare themselves to their individual peer group. Peer group indices exist for each of these and some have decile and quartile performance reporting, enabling us to rank our client's performance by decile or quartile. Another peer group is our own Partners Capital client base, which can be grouped by type, geography and currency for comparisons. We would argue that the most important peer group adjustments that need to be made include overall risk level, private markets allocation and asset allocation. For example, the average NACUBO university endowment in the category of $100M to $500M AUM has a relatively low allocation to private equity (c 10%) compared to our clients who will have closer to 30% private equity. It is relatively easy to adjust for this.

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Asset Manager Benchmarking: Each client's Investment Policy Statement should define how asset manager performance will be evaluated as there is a rangeof views on what the right benchmark is and over what timeframe manager performance should be evaluated. Asset managers are notorious for not having, in our opinion, the appropriate benchmark to evaluate their performance. Please see our whitepaper on "How to Evaluate Investment Performance." There are two very different benchmarks for asset managers: 1) a peer group benchmark such as HFRI merger-arb for a merger-arb hedge fund and 2) a beta-based benchmark which is constructed from the normative set of betas that the manager's past performance and current exposures would suggest are appropriate (e.g., 0.8 beta to MSCI World for GMO Quality fund). Manager benchmarking is much more complicated, a topic that is warranted in this whitepaper. For performance assessment, we generally look at a managers' normative exposures to seven core betas (DM equity, EM equity, credit, inflation, rates, commodities and property beta), geographic exposure, sector exposure, as well as many different risk factors including style (quality, value, growth), liquidity and size (microcap, small-cap). The time frame is also controversial, but our strong view is that we need at least 5 years to evaluate manager performance, but qualitative factors (like deviations from strategy, team turnover) can have us redeeming much earlier.

Asset Manager Performance Benchmarking: beta replication over a 5-year time frame.

Benchmark Name	Benchmark Definition	Message in the comparison to the Benchmark	Meaningful measurement period
Long-term return target	Defined in the IPS and is usually the nominal return desired or required over the very long-term	Are we earning what we set out to earn? The most important long-term benchmark	Rolling 10 years
Equity/Bond reference index	A % of the MSCI ACWI equity index and % of the Global Bond index; e.g., 70/30 equity/bond index. May use local currency 10-yr Govt bond returns in lieu of global bonds. Can use "investable indices" which include fees and other costs by using an actual ETF's performance.	Are we beating the simplest of passive portfolios with similar risk levels?	Rolling 5 years
SAA Composite Benchmark	Calculated using the performance of representative asset class indices weighted by the target allocation to that asset class in the portfolio's long-term strategic asset allocation per the IPS. Should use investable benchmarks (e.g., ETFs.)	The most important benchmark for short term performance assessment. Are we beating an investable passive version of our portfolio?	Annual, 3-year, 5-year and 10-year
Peer group benchmark	Endowment peer group is usually the NACUBO (US university endowments) published performance figures which comes out on a YE June time frame. Family office benchmarks exist from Northern Trust, KPMG and others. Peer groups can be created from a defined set of peers on a customised basis.	Usually, can conclude where we rank by quartile against some of these benchmarks. Will need to adjust for risk, illiquidity and asset allocation differences.	Annual and 3-year
Individual asset manager benchmarks	There are two very different benchmarks for asset managers: 1) a peer group benchmark such as HFRI merger-arb for a merger-arb hedge fund and 2) a beta-based benchmark which is constructed from the normative set of betas that the manager's past performance and current exposures would suggest are appropriate (e.g., 0.8 beta to MSCI World for GMO Quality fund).	Should we keep the manager? Are they beating their fees and is the alpha proportionate to alpha risk? (i.e., is the information ratio high enough?)	Rolling 5 years

Source: Partners Capital

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A word about so-called Absolute Returns

We all-to-often come across asset owners who have an "absolute return" philosophy which says they do not believe it meaningful to compare performance against anything other than their target; so no market-based benchmarks. While the comparison to target return does matter the most in the very long term, there is no information of value from comparing actual annual performance to a target return over a 12 month period or even over three years. We believe there is advance information on whether you will achieve your long-term target by comparing a portfolio to passive market metrics like the SAA benchmark over shorter periods of time, even quarterly. At the end of the day, portfolios include risk and there are market-based measures of expected returns for taking certain amounts and types of risk. This is what investment returns come from. As we say in our "Investing 101" whitepaper, rule number 1 – there is no return without risk. No portfolio is devoid of risk, so no portfolio should go without having its returns measured against the expected returns for the risks they are taking. This points to always comparing performance against the passive risk-equivalent benchmark.

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