MARKET INDEXES AS BENCHMARKS

The Good, the Bad, and the Ugly

By Jeremy Wadsworth

The first stock market index was created in 1896 by Charles H. Dow. That market index, which he aptly named the Dow Jones Industrial Average (DJIA), was an average of the top 12 stocks in the market. Over the next few decades, other companies began developing alternative indexes and mechanisms that could measure the movement of the overall market. In 1946, the S&P 500 as we know it today was published. These indexes helped bring transparency and a better understanding of the markets to investors. An unforeseen consequence at the time, however, was the influence indexes eventually would have on the investor’s decision-making process. Market indexes such as DJIA and S&P 500 have become mainstays of the investment industry. Today, almost every fund manager is compared to the most relevant index, and almost every financial advisor is compared to the performance of the overall market. But a clear distinction must be made between an index and a benchmark. An index is a group of securities gathered together to provide a measure of a market. A benchmark, though, is a tool used to judge the relative performance of a stock manager/advisor. Market indexes have become the industry’s unrivaled benchmark. Many advisors accept indexes as a natural part of the industry and their work, but these man-made yardsticks need to be thoughtfully understood. This article provides a framework that can help advisors think about indexes and benchmarks and explain them to clients. The rise in prominence of market indexes has been accompanied by many influential and largely unintended consequences—some of them good, some of them bad, and some of them rather ugly.

The Good

The use of market indexes as the investor’s primary benchmark has had several significant, positive influences on the investment industry. Benchmarking against an index is simple to execute, easy to comprehend, and creates a quantifiable goal for a manager. These traits have simplified investing for the general population. By increasing understanding and clarity regarding the markets, indexes have given individuals the confidence to put their hard-earned dollars to work in the market. Indexes have developed transparency for the average investor as well as the media, making investing and the markets part of everyday life.

Furthermore, market indexes have revolutionized the investment industry through investment products designed to track market indexes. These passive investments track the performance of a given market index at a very low cost to investors—sometimes as low as only a few basis points, allowing investors to gain exposure to an asset class at virtually no cost. This innovation has had widespread effects, especially in recent years, because active managers have been forced to justify the higher fees associated with their products. Margin pressure has occurred across the industry and fees have been lowered almost universally, certainly an advantage for investors. These benefits cannot be undervalued and have transformed the investment industry in a positive manner.

The Bad

Market indexes have brought big-picture benefits to the investment industry, but they make poor benchmarks for the following reasons:

1. Indexes do not incorporate transaction costs, expense ratios, or tax consequences.
2. Indexes shift the focus to security selection rather than asset allocation.
3. Many asset classes have several accepted indexes that have varying risk and return characteristics.
4. Indexes may not focus or align with a client’s specific goals.
5. Managing to an index may lead to poor long-term performance.

Indexes Do Not Incorporate Transaction Costs, Expense Ratios, or Tax Consequences

The S&P 500 may accurately estimate the overall movement of the U.S. equity market, but investing directly in the S&P 500 at zero cost is impossible. Exchange-traded funds (ETFs) and mutual funds have expense ratios, transaction costs, and bid-ask spreads (for ETFs) that the investor must pay. Therefore, if a market index is technically unachievable, does it make sense to compare a manager to it? If the goal of a manager is to beat a benchmark, shouldn’t the benchmark be a realistic investable alternative? Shouldn’t the benchmark represent a viable option if the investor chose to invest alone, without the manager?

This may seem trivial, but additional examination illuminates the conundrum. Instead of using the S&P 500, consider using an S&P index fund as a benchmark. Index funds are readily investable options, often have no transaction fees on some custodial platforms, and typically have extremely low expense ratios. Comparing a fund manager to an S&P index fund would largely result...
in the same conclusions as if one compared the fund manager to the S&P 500. However, this story does not work for all asset classes. Commodities, for instance, do not have a fund that closely tracks an accepted index for an extremely low cost. For example, the DFA Commodity Strategy is the cheapest commodity fund available (expense ratio of 0.34 percent) and is one of the most index-like funds an investor can find in the commodity space. In this case, there is a higher possibility that a fund manager may underperform the Bloomberg Commodity Index, the most widely accepted commodity index, but outperform the DFA fund, a realistic investable alternative. Put simply, a pure index does not represent a genuine comparison.

Additionally, indexes do not incorporate any tax consequences. For U.S. equities, one could use a passively managed ETF, which rarely distributes capital gains or income, as a benchmark rather than the S&P 500, and including tax consequences would not make a substantive difference. Other asset classes, however, are not as tax-efficient. Within real estate, for example, there can be a large discrepancy between the pre-tax return for a fund and the after-tax return for a fund.

For example, table 1 shows that the PIMCO Real Estate Real Return fund outperformed the Vanguard REIT Index fund by 3.2 percent over the past 10 years on a pre-tax basis. On an after-tax basis, however, the PIMCO fund underperformed the Vanguard fund by 0.8 percent. The tax efficiency of the Vanguard fund made it a better option in a taxable account despite the reported lower return. For any investor who is purchasing real estate in a taxable account, comparing the after-tax returns is essential. Market indexes do not take into consideration any tax consequences, so a reasonable comparison is difficult.

Table 1: 10-Year Return, Real Estate

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>Pre-Tax Return</th>
<th>After-Tax Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>PIMCO Real Estate Real Return Strategy I</td>
<td>8.3%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Vanguard REIT Index Fund Investor</td>
<td>5.1%</td>
<td>3.8%</td>
</tr>
</tbody>
</table>

Note: Return data ending December 31, 2016

This example does not make the case for passive management; outperformance of a benchmark within an asset class certainly adds long-term value. This example shows how asset allocation can have a greater effect than specific manager performance on long-term returns. Across the industry, significant resources and time spent with clients are focused on benchmark-oriented returns within an asset class, and less attention is placed on asset allocation. By focusing on benchmark-relative returns, the investment industry may have its priorities backward when allocating time and resources.

Table 2 shows that Investor A outperformed Investor B in every single asset class. But Investor B outperformed Investor A on a total portfolio basis due to asset allocation decisions. Many people would not question the allocation difference between Investor A and Investor B because both have a 30-percent allocation to fixed income. The outperformance was due to larger allocations to international equities and real estate, both of which produced stronger returns than U.S. equities.

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Table 2: Asset Allocation

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Allocation</th>
<th>Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Income</td>
<td>30% A</td>
<td>6% A</td>
</tr>
<tr>
<td>U.S. Equities</td>
<td>40% B</td>
<td>11% B</td>
</tr>
<tr>
<td>International Equities</td>
<td>20% A</td>
<td>21% B</td>
</tr>
<tr>
<td>Real Estate</td>
<td>10% B</td>
<td>15% B</td>
</tr>
</tbody>
</table>

One way to emphasize asset allocation decisions may be to select a diversified portfolio or fund as a benchmark when evaluating financial advisors. Several examples fit this profile, including the Vanguard LifeStrategy funds, the BlackRock Target Allocation funds, and the Fidelity Asset Manager funds. These funds typically invest in U.S. bonds, international bonds, U.S. equities, and international equities through low-cost passively managed vehicles.

Utilizing one of these funds as the primary benchmark would bring the allocation decisions made by the advisor to the forefront of the conversation. An advisor who is developing model portfolios for clients would be judged more accurately against one of these funds (assuming equal levels of risk) rather than by being measured asset class by asset class.

Many Asset Classes Have Several Accepted Indexes That Have Varying Risk and Return Characteristics

There are now more than 40,000 approved indexes in the investment world today, per Zephyr StyleAdvisor. Of course, many of these indexes are sector-specific, country-specific, or country-and-sector specific.
Regardless, the sheer number of indexes presents a problem. How does an investor choose an index to compare against a manager? U.S. real estate investment trusts (REIT), for instance, have several globally accepted indexes that can produce very different comparisons, as shown in table 3.

A quick comparison of the two largest U.S. REIT mutual funds, Vanguard REIT Index and DFA Real Estate Securities Portfolio, highlights the disparity among the returns for these indexes. Together, these funds have approximately $69 billion under management and account for roughly 52 percent of the entire U.S. REIT mutual fund industry. Despite their prominence, they utilize different benchmarks. The Vanguard fund compares itself to the MSCI US REIT index, and the DFA fund makes use of the DJ US Select REIT index (see table 4).

An investor comparing each fund to its benchmark may conclude that the DFA fund was earning much stronger returns than the Vanguard fund, when in fact, the Vanguard fund had outperformed the DFA fund. This issue is not confined to obscure asset classes or small funds; this is occurring in well-accepted asset classes with the largest mutual fund offerings available. This lack of continuity can make investment decisions extremely difficult for individuals. It is not a question of merit—both indexes accurately represent the U.S. REIT market. By selecting a realistic investable option as the benchmark, investors and advisors alike can mitigate this issue.

Indexes May Not Focus or Align with a Client’s Specific Goals

Attempting to ensure top-percentile returns, investors tend to focus on benchmark comparison returns. This can cause investors to lose focus on why they are invested in the first place—to achieve specific, personal goals. Whether it is to save enough for retirement, leave an estate for heirs, preserve capital, achieve high growth, or some combination of the above, each investor has an explicit goal in mind. Beating a benchmark return by 0.5 percent, for instance, is meaningless if the absolute return or volatility is sabotaging the defined goal.

The energy and resources put into beating a benchmark detract from the most important factor—how is the client doing in relation to the goal? Is the client earning a high enough rate of return? Does the client need to take on more risk? Less risk? Decrease spending? Can the client increase spending? These are the questions and conversations that matter to the client and will have a greater effect on the client’s life, and advisors should be taking it upon themselves to focus on these issues. The client-advisor relationship is built on trust, and the client will concentrate on the topics that the advisor brings up at meetings. The conversation between the advisor and client should address the client’s saving rate, for example, and not necessarily how the client’s international equity fund performed against the MSCI EAFE. Clients take cues from their advisors regarding what is important. If advisors place more emphasis on the big-picture conversations, clients will follow. The result will be a more optimal long-term plan to ensure that clients are achieving their goals.

Along these lines, it is worth noting the manner in which indexes are constructed and reformulated. The 500 stocks in the S&P 500, for instance, are selected by the S&P Index Committee, a team of analysts and economists. How are the decisions made by this committee relevant to the goals of a client? By tracking an index, investors are inadvertently subject to the decisions made by this committee.

Since 1965, 22 companies have been added or removed from the index each year on average. Millions of investors who are focused on index returns experience alterations to their portfolios that do not reflect any changes in their individual situations or portfolio needs.

Managing to an Index May Lead to Poor Long-Term Performance

Fixation on benchmark comparisons has led fund managers and financial advisors to become very sensitive to tracking error. This is not necessarily the manager or advisor’s fault; there is substantial business risk of losing clients if returns vary significantly from the benchmark. However, this in turn forces managers to prioritize, or at least seriously consider, the portfolio’s risk exposures relative to the designated benchmark risk exposures. A portfolio manager may decide to alter the portfolio to ensure a minimal level of tracking error as opposed to an optimal risk-return profile. These decisions, when aggregated across all fund managers, likely diminish long-term performance for investors. Some academic studies have shown that mutual funds that exhibit greater style drift, which occurs when a manager moves between different Morningstar style box

<table>
<thead>
<tr>
<th>Table 3: Comparison of REIT Indexes</th>
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<tbody>
<tr>
<td>Fund</td>
</tr>
<tr>
<td>Dow Jones US Select Real Estate Securities</td>
</tr>
<tr>
<td>Dow Jones US Select REIT</td>
</tr>
<tr>
<td>S&amp;P United States REIT</td>
</tr>
<tr>
<td>MSCI US REIT</td>
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<tr>
<th>Table 4: One-Year Returns</th>
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<tbody>
<tr>
<td>Fund</td>
</tr>
<tr>
<td>Vanguard REIT Index</td>
</tr>
<tr>
<td>DFA Real Estate Securities Portfolio</td>
</tr>
</tbody>
</table>

Note: Return data ending 12/31/2016
classifications, earn excess returns compared with counterparts that are constricted to a style box.\textsuperscript{1} Many funds are forced to stay within a style box due to pressure from investors and advisors alike. These funds are punished by a loss of assets under management if they stray too far from the designated benchmark. Funds that are not beholden to a benchmark or an arbitrarily constructed style box are more likely to produce stronger long-term returns.

A financial advisor may select a fund option because the advisor is confident the fund will move in sync with the designated benchmark even though the advisor may believe there is an alternative option that would provide stronger returns over the long term. Client behavior and business risk could dictate that the advisor will make the suboptimal decision. Removing the concentration on index comparisons would reduce pressure on fund managers and advisors to closely resemble the return pattern of an index. Managers would be able to spend more resources on developing portfolios that align with their investment theses (i.e., value, growth, momentum, etc.) without concern for an arbitrary benchmark return. This may lead to stronger long-term returns despite any higher tracking error.

**The Ugly**

Few people like to talk about or even acknowledge the ugly side of the industry’s reliance upon market index benchmarks—the opportunity they provide for financial advisors and fund managers to manipulate client interactions by retroactively selecting benchmarks that create the appearance of strong portfolio performance. Outside of U.S. equities and the S&P 500, a small minority of clients and investors track markets such as international equities, emerging markets, and real estate, and they rarely know which market index to follow. A lack of knowledge on the investor’s part paired with the flaws of market indexes create an opening for advisors to potentially manipulate performance measures to enhance the appearance of their work.

The U.S. Securities and Exchange Commission requires fund managers to include in their annual reports comparisons of their performance to an “appropriate broad-based” securities benchmark.\textsuperscript{2} This is vague language at best and does not prohibit a fund manager from switching the benchmark when it suits the fund. The lack of clarity and understanding regarding benchmarks, even among advisors, creates avenues for potential abuse.

**Conclusion**

The effects stemming from the ever-increasing presence of market indexes within the investment industry have produced conflicting results. Market indexes have brought greater systemic understanding to a largely cloudy world and have lowered the cost of investing for millions. But advisors should not be so quick to accept market indexes as defaults for benchmarks. The use of market index benchmarks is laden with the potential for unintended consequences. Advisors with greater understanding of the issues surrounding the use of market indexes as benchmarks will promote discussions with clients and advance transparency within the investment world.

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**Endnotes**
