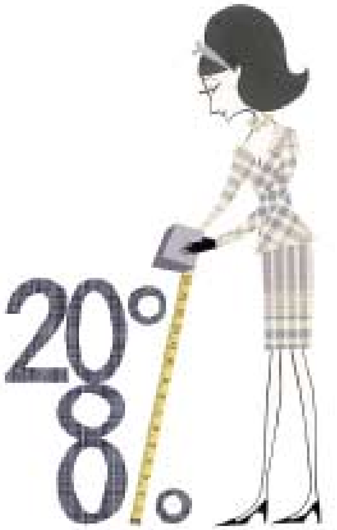
The Measure for Measures

An advisory think tank explores the whys and wherefores of what advisers want in a benchmark

Mary Rowland



AT THE END OF APRIL, MEMBERS OF the advisory board of the TIAA-CREF Institute spent some time talking about benchmarking client portfolios. They invited me to sit in on the session. For advisers, benchmarking has worked its way up the list of hot topics. So I'll share with you some of what they had to say.

The institute's board is a group of 12 finance professionals—mainly financial advisers—who get together three times a year in New York to discuss issues they'd like to see researched by economists and others on the institute staff. I doubt very much whether these advisers' clients—or yours—could have followed much of the discussion. Planners are concerned, as well they should be, about diversifying client portfolios and choosing the proper yardstick to measure the performance of the portfolio managers and separate-account managers they use and to keep tabs on the individual stocks they buy on their own for clients. Still, when it comes to benchmarks and what they're meant to tell us, the average investor doesn't get it. He tunes in to Bloomberg Radio and Bloomberg Television for news or logs on to the Internet to check his portfolio and the performance of the 30 companies in the Dow Jones industrial average and, of course, of those in the Nasdaq Composite Index. Then he takes a look at his own portfolio and wonders why he hasn't done as well.

This is a problem I've discussed from time to time with Roger Gibson, president of Gibson Capital Management in Pittsburgh. During the late 1990s, he'd been doing pretty well for clients, achieving returns of more than 20 percent in 1999. But those were not the kind of outsize returns his clients' friends were earning with companies such as Cisco Systems, Sun Microsystems, Global Crossing, and Corning. When one sector is outpacing every other, a diversified portfolio is a tough sell, regardless of which benchmarks you use. Gibson lost a group of doctors at the beginning of 2000 who had been his clients for 20 years. They moved all their money into large-cap growth, which at that time meant technology. My guess is they won't be retiring as early as they'd hoped.

I asked Gibson at the TIAA-CREF meeting if he ever questioned himself and his benchmarks in the late '90s. He did. "That was part of my existential crisis," he said. "How could clients continue to believe it when I was losing faith myself?"

Advisers had their faith in benchmarks restored sooner than the rest of us. But I still think the planner's biggest job is to keep the client on board and drill home the idea of a diversified benchmark. During the 1990s tech craze, when advisers called cautionary attention to the recession and bear market in 1974–75 that followed the tripling of oil prices by OPEC, nobody wanted to listen. Now, of course, advisers have a more recent calamity to point to.

But on the subject of managing a client's expectations about returns, the compelling question that came up during the discussion was—how good is good enough? If you set goals with your client and you agree that he needs 8 percent to achieve them, does that mean 8 percent should suffice? What if his friends are earning 20 percent? Should you play it conservatively because he needs only 8 percent? Or do

Illustrations by Mary Lynn Blasutta

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you have a fiduciary responsibility to do better than 8 percent if it's possible to do so within his risk parameters? In other words, as one adviser asked, how do I benchmark myself? At what point would I fire myself? To keep your clients on board, I think you have to be able to answer that question. And, of course, you want an answer for your own satisfaction as well.

One adviser offered a complex solution: he splits client portfolios into asset classes and benchmarks each asset class against an index specific to that class. Then he creates a blended benchmark that might have, say, 6 percent small-cap value and so forth for each class. The benchmark has no expenses. And he measures his client portfolios against it. The group seemed intrigued, but no one listening seemed ready to sign on. "That takes real courage," another planner said.

We talked about the universe of indexes and what makes one better than another. I even learned of some I'd never heard of: the CRSP (Center for Research in Securities Prices) indexes, which provide detailed information for the underlying stocks and are used by academics and institutional money managers. The Ibbotson data are drawn from these indexes. The group seemed to have a slight bias toward the methodology of the Russell indexes because of the transparency of the selection process and rebalancing. Several people depicted the approach as cleaner and purer than the one used for Standard and Poor's indexes. The nine-person committee that decides which stocks should be added or dropped from the S&P indexes makes the process somewhat mysterious. Advisers were also concerned about the effects on a stock that's added or dropped from the S&P indexes.

The advisers wanted an index that's unambiguous, with clear, transparent, and published rules. They want it to be measurable, appropriate, and backed by some history. And if it's not investable, it's not helpful. Someone mentioned the new iShares exchange-traded fund based on the Goldman Sachs Natural Resources Index, which puts a new spin on commodities indexing.

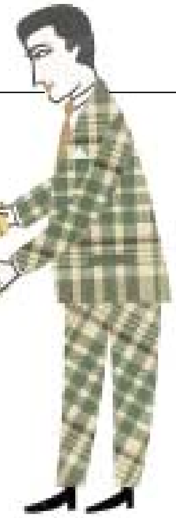
The discussion got especially interesting when it turned to how an index is structured—whether by replication of all the stocks, by a sampling method, or by a stratified sampling, which might dip into industry sectors and also the growth-versus-value split. The advisers seemed to be growing skeptical of the entire growth-versus-value argument. "Can we even identify what is growth and what is value?" one planner asked. Another suggested that "the Morningstar style boxes have conspired to keep us in this two-dimensional universe."

And however the universe is defined, how closely should active managers be held to a benchmark? "Are we giving the horses enough room to run?" one adviser wondered. To provide a good measure, the beta of the index should be as close to one as possible with the beta of the active manager. At one point, Nortel Networks Corp. made up a third of the S&P/TSX Composite Index, one adviser said, whereas technology was around 36 percent of the Standard & Poor's 500 stock index. That doesn't make either one much of a benchmark for a value manager.

The returns of the various indexes tend to be highly correlated, but the indexes are less highly correlated by other measures. Turnover, for example, is much higher in some than in others, as is tracking error. In 2000 some unseasoned companies came out of the gate and moved right into the Russell 1000 Index and then blew up, one adviser reminded us.

WHO'S WHO

TIAA-CREF INSTITUTE'S ADVISORY BOARD granted me permission to write about the material discussed in the session as long as no one was quoted, but I can at least tell you the names of the participants. Besides the chairman, Harold Evensky, principal at Evensky, Brown, and Katz in Coral Gables, Fla., other advisers on the board include Eleanor Blayney, principal of Sullivan, Bruyette, Speros & Blayney in McLean, Va.; Janet Briaud, owner of Briaud Financial Planning in Bryan, Tex.; Tom Connelly, president of Keats, Connelly & Associates in Phoenix; Roger Gibson, president of Gibson Capital Management in Pittsburgh; Patricia Houlihan, CEO of Houlihan Financial Resource Group in Oakton, Va.; and David Polstra, chair of Polstra & Dardaman in Norcross, Ga. Also serving are two "nonplanners": J. Thomas Bradley, president of TD Waterhouse Institutional Services in San Diego, and Nicholas Souleles, professor of finance at the Wharton School, University of Pennsylvania. Economists and others from TIAA-CREF joined them. —*MR*



Because of the committee process, they never made it into the S&P indexes.

Just before this meeting, Morningstar had announced it would change its star ratings to rank a fund within its sector rather than within, say, the entire universe of U.S. stocks. And Morningstar announced late last year that it would introduce new style-based indexes, a change welcomed enthusiastically by these advisers.

Discussions like these are useful, but are benchmarks really all that important to advisers? As I've argued before, in the list of important services planners provide, investing ranks near the bottom. I don't dispute the complexity of choosing investments, but a well-diversified portfolio like the one in, say, the Vanguard Star Fund—a low-cost fund of funds that invests in several other Vanguard funds without an additional layer of fees—would serve most investors well. That's assuming they just stay put. More challenging than creating a portfolio is explaining to clients why they should stick with it. The Vanguard Star Fund isn't a bad proxy. And it's a measure that clients can understand.

To me, the most important question raised in this discussion was the one about which benchmark advisers should use on themselves. Here's one possibility: if I were a planner and I couldn't get a better return than Vanguard Star Fund, I'd can it.

Mary Rowland is the author of Best Practices for Financial Advisors *(Bloomberg Press). She speaks regularly to advisers about practice-management issues.*