QuickCourse

Benchmarking Returns

To be in-the-know and in control over your investments, you need to have answers to two important questions about your account: "how is it doing?" and "compared to what?"

This module provides you with an easy way to compare the return on your account against a benchmark that accurately represents how the investments in your account are allocated. This method uses time-weighted returns, which are generally used for comparing the return of an investment, or a whole account, against a benchmark.

While other, more accurate (and more complicated) methods for measuring performance exist, the 11-step process used in this module is easy to follow and easy to do. Using only simple addition, subtraction and multiplication, you'll arrive at a "close enough" comparison between the return on your account and the return on a representative benchmark. First, some definitions are in order:

Index

An index is a method of measuring the value of a financial market e.g., the stock market or the bond market. An index can represent a broad market such as the S&P 500 Stock Index or the Barclays Capital US Aggregate Bond Index, or segments of a broad market such as the Dow Jones US Technology Index. Indices can also represent the market of a region, for example the MSCI European, Australasian, and Far Eastern (EAFE) Index or of a nation, for example the British FTSE 100. There are thousands of indexes. Some of the more popular indices include the S&P 500, the Dow Jones Industrial (Average), and the NASDAQ 100.

Benchmark

A benchmark is a standard against which the performance of a security, mutual fund or broker/adviser can be measured. Generally, an index or an index mutual fund/ETF (exchange traded fund) is used as a benchmark. The objective of actively-managed mutual funds is to out-perform a representative benchmark, net of fees, when measured over a multiple-year period. Note: An index is a mathematical construct. You cannot invest directly in an index.

Let's get started

1. **Select the measurement period e.g., quarter-to-quarter, end-of year.**

   To get started, select the reporting period you want to use. As a practical matter, use your most recent quarter-end or year-end statement.

2. **Categorize the individual investments within your account by asset class.**

   Look at each investment in your account and determine whether it's composed mostly of stocks, bonds, cash or other asset classes such as real estate or natural resources. Your brokerage account/retirement plan account

statement typically categorizes your investments this way.
Other sources include:

- ☐ Your employer-sponsored retirement plan provider (for investments you own within the retirement plan)
- ☐ Mutual fund prospectuses / fact sheets
- ☐ Mutual fund/ETF company websites
- ☐ Mutual fund/ETF rating and ranking services
- ☐ Financial/investment-related websites

Categorization example:

<u>Asset Class: Stocks</u>
ABC Large Cap Growth Fund
XYZ Large Cap Value Fund
DEF Small Cap Fund

<u>Asset Class: Bonds</u>
ABC Corporate Bond Fund
XYZ U.S. Government Bond Fund

3. List the beginning period value of each investment within each asset class. For example:

Asset Class: Stocks	Beginning Value
ABC Large Cap Growth Fund	$20,000
XYZ Large Cap Value Fund	$20,000
DEF Small Cap Fund	$20,000
Total Stocks	$60,000

Asset Class: Bonds	Beginning Value
ABC Corporate Bond Fund	$20,000
XYZ U.S. Government Bond Fund	$20,000
Total Bonds	$40,000

4. Calculate the percentage each investment represents of the total account value. You do this by dividing the dollar value of the investment by the account value. For example:

Beginning Period Account Value: $100,000

Asset Class: Stocks	Beginning Value	%
ABC Large Cap Growth Fund	$20,000	20%
XYZ Large Cap Value Fund	$20,000	20%
DEF Small Cap Fund	$20,000	20%
Total Stocks	$60,000	60%

Asset Class: Bonds	Beginning Value	%
ABC Corporate Bond Fund	$20,000	20%
XYZ U.S. Government Bond Fund	$20,000	20%
Total Bonds	$40,000	40%
Total Account Value	$100,000	100%

5. Next, get the published return of each investment for the period being measured. This information is available from:

- ☐ Your employer-sponsored retirement plan provider (for investments you own within the retirement plan)
- ☐ Mutual fund prospectuses / fact sheets
- ☐ Mutual fund/ETF company websites
- ☐ Mutual fund/ETF rating and ranking services
- ☐ Financial/investment-related websites

For example:

Investment	Return
ABC Large Cap Growth Fund	11%
XYZ Large Cap Value Fund	10%
DEF Small Cap Fund	12%
ABC Corporate Bond Fund	4%
XYZ U.S. Government Bond Fund	2%

6. Then calculate the 'weighted return value' for each investment. You do this by multiplying the investment's percentage weighting in the account by its return. For example:

Investment	Return	Weighted Return Value
ABC Large Cap Growth Fund	11%	20 X 1.11 = 22.2
XYZ Large Cap Value Fund	10%	20 X 1.10 = 22.0
DEF Small Cap Fund	12%	20 X 1.12 = 22.4
ABC Corporate Bond Fund	4%	20 X 1.04 = 20.8
XYZ U.S. Government Bond Fund	2%	20 X 1.02 = 20.4

7. Add-up the weighted return values.

Investment	Return	Weighted Return Value
ABC Large Cap Growth Fund	11%	20 X 1.11 = 22.2
XYZ Large Cap Value Fund	10%	20 X 1.10 = 22.0
DEF Small Cap Fund	12%	20 X 1.12 = 22.4
ABC Corporate Bond Fund	4%	20 X 1.04 = 20.8
XYZ U.S. Government Bond Fund	2%	20 X 1.02 = 20.4
Account Overall Return		107.8

8. Next, subtract 100 from the total. In this example, the overall return on the account was 7.8%.

Knowing the return is important, but by itself it isn't really helpful. It doesn't tell you whether the return was competitive or underperforming based on how your investments were allocated. To determine this, the return needs to be measured against a representative benchmark. How do you do this?

9. Get the representative benchmark for each investment. This information is also available through:

- ☐ Your employer-sponsored retirement plan provider
- ☐ Mutual fund prospectuses / fact sheets
- ☐ Mutual fund/ETF company websites
- ☐ Mutual fund/ETF rating and ranking services
- ☐ Financial/investment-related websites

Applied to the example account, a blended benchmark might be:

Account Asset Allocation	Blended Benchmark Example
40% Large Cap Stock Funds	40% S&P 500 Index
20% Small Cap Fund	20% Russell 2000 [Small Cap] Index
40% Bond Funds	30% BarCap U.S. Aggregate Bond Index

10. Next, get the published return for each benchmark for the period being measured. Then calculate the 'weighted return value' for each benchmark. Then add-up the weighted return values. For example:

Blended Benchmark Example	Return	Wtd. Return Value
40% S&P 500 Index	11%	40 X 1.11 = 44.4
20% Russell 2000 Index	10%	20 X 1.10 = 22.0
30% BarCap U.S. Agg. Bond Index	2%	40 X 1.02 = 40.8
Benchmark Return		107.2

Next, subtract 100 from the total. In this example, the benchmark return was 7.2%.

11. Compare the return of the account to its benchmark:

Portfolio Return	7.8%
Benchmark Return	7.2%

In this example, the account out-performed its benchmark by 0.6% for the measurement period.

Measuring your account return against a benchmark lets you know what's working, what's not working, and provides direction for addressing underperformance. For example, you can analyze each investment against its benchmark:

Investment	Return	Benchmark	Return
DEF Small Cap Fund	12%	Russell 200 Index	10%

You can also analyze an investment category against its benchmark. For example:

Investment	Return	Benchmark	Return
ABC Lg. Cap Growth Fund	11%	S& P 500 Index	11%
XYZ Lg. Cap Value Fund	10%		

Investment	Return	Benchmark	Return
ABC Corporate Bond Fund	4%	BarCap U.S. Agg. Index	2%
XYZ U.S. Gov't Bond Fund	2%		

Calculate the return on your account(s) at least annually.

Note: Gaining in popularity among brokers/advisers is goals-based investing. This approach manages your account to your financial goals and measures its return against a goals-based 'bogey' instead of against an external, index-based benchmark like the S&P 500 Index, for example. The argument is that the most important context is you and your goals - not the financial marketplace, and that meeting your financial goals is more important than beating the markets. In this context, "good performance" is a return that meets or beats your target return and keeps you moving ahead toward your goals, while "poor performance" is a return that has you falling behind. While measuring returns in the context of your goals may be the central consideration, it should not replace measuring returns against an external benchmark. Moving closer to goals while lagging behind an external benchmark is trouble. Falling behind on your goals-based benchmark while under-performing an external benchmark is double trouble.