

## Benchmarking Basics – A Fiduciary Perspective

Our team of Investment Advisors meets regularly with non-profit organizations and their fiduciary boards and investment committees to develop and refine investment policies. Often, the conversation turns to measuring the success of the investment program and setting appropriate benchmarks. To assist fiduciaries in answering the important question of “How are we doing?” this paper will address:

- How fiduciaries should use benchmarks
- Common types of benchmarks used for evaluation
- Constructing benchmarks at the total portfolio level

### What is a benchmark and how should fiduciaries use them?

A benchmark is a measurement tool that provides a reference point for determining the success of an investment strategy and to confirm achievement of a goal. We'll explore three types of benchmarks that can be useful at both the individual manager level and at the total portfolio level – Market Indices, Peer Groups, and Absolute Return Indices.

The use of benchmarks as reference points help fiduciaries to answer the important questions of “How are we doing?” – versus the market, versus peers and versus goals. Benchmarks help support fiduciaries in their obligation to monitor and evaluate performance. At the manager level, benchmarks serve as standards for measuring the value generated by active money managers. At the total portfolio level, benchmarks allow fiduciaries to understand how their investment program is doing relative to the established goals and mission of the organization and to help determine if they're making good decisions.

Investment committees may meet as often as quarterly to review portfolio and performance results. Given this frequency, it can become easy to focus on short-term periods of relative performance versus a benchmark which can ultimately lead to poor decision making. By nature, institutions generally have a long-term time horizon, often in perpetuity, which aligns with a longer term performance evaluation period. Institutions should consider a full market cycle of 5 years.

### Asset Class Benchmarks and Market Indices

Traditional asset classes commonly use market indices as benchmarks. A market index is a reference portfolio of securities that is used to measure the value of a particular market. There are a wide variety of indices available to track equity and fixed income asset classes across market capitalizations, styles and sectors. Market indices are commonly used benchmarks for performance evaluation because the data is widely available and fairly easy to understand. There are dozens of indices that could be used to evaluate the performance of any given investment. Common index providers include MSCI, known for global equity markets; Russell, known for US equity market and style sub-sets; and Barclays, covering fixed income sectors, among many others. Each of these providers has its own index construction methodology. Often, equity indices are constructed by a capitalization weighted method, whereby the largest market cap company in an index comprises the largest weight of the index. Therefore, a large price move in the largest company in an index can have a dramatic effect on the value of the index on any given day.

In contrast to traditional asset classes where there is a broad array of investable market indices to choose from, benchmarking in the alternative investments space is much different. There are no market indices to track these strategies; thus, peer universes are used to construct benchmarks such as HFRI (Hedge Fund Research Indices) that reflect hedge fund managers in the HFR database. However, since many diversified hedge fund investments offer differing investment strategies, it can be challenging to identify an appropriate peer group that represents a specific strategy. In addition, hedge fund benchmarks are not investable and suffer from survivor bias as described below. All of these factors present challenges in selecting benchmarks for alternative strategies.

## Characteristics of a Good Benchmark

According to the Research Foundation of CFA Institute, “the most informative assessment of investment performance occurs when the benchmark has certain basic properties:

Unambiguous	the benchmark should be clearly understood by all parties involved in the investment program
Investable	the benchmark should represent an investable alternative; that is the trustees could choose to hold the benchmark rather than hire the particular manager
Measurable	the benchmark’s rate of return should be readily calculable
Appropriate	the benchmark should reflect the manager’s typical risk characteristics and area of expertise
Specified in Advance	the benchmark must be specified prior to the evaluation period and known to all interested parties
Owned	the benchmark should be acknowledged and accepted as an appropriate accountability standard by the party responsible for the performance”

Source: *A Primer for Investment Trustees, The Research Foundation of CFA Institute 2011.*

## Peer Groups

At the manager level, peer universes reflect investment managers with similar investment objectives. These are useful when evaluating the relative merits of an active management strategy, providing another layer of context to index comparisons. Investors often try to gauge a manager’s skill by comparing the manager’s performance to the performance of a group of similar managers. Common manager peer universes include eVestment Alliance, Morningstar and Lipper. Each has its own construction methodologies.

In evaluating total portfolio performance versus peer groups, there are many sub-sets of institutional peer groups available; for example, community foundations, private foundations, charitable organizations, and endowments, to name a few. These organizations often use peer group analysis to learn how the investment portfolios of similar organizations are performing and what they may be doing differently. This information may help improve investment outcomes and demonstrate to potential donors that they are prudent stewards of assets.

Many charitable organizations refer to the NACUBO-Commonfund Study of Endowments (NCSE) for peer universe data because of the detailed level of reporting it provides on asset allocation and investment performance. The data is widely publicized and is comprised of a large number of the nation’s endowments for institutions of higher learning (832 for FYE 2014) reporting return and asset allocation data which is segmented by asset size. Returns are also broken out by asset class and market size for more detailed comparisons.

While NCSE may be a very relevant peer group for educational endowments, other types of non-profit organizations should keep in mind that these endowments have the ability to raise additional funds to meet their obligations during times of market drawdowns and liquidity constraints. Many of the largest endowments that report to NCSE have a solid base of potential donors they can rely on for financial support during difficult times. Other non-profits, such as private foundations and some types of charitable organizations, may not be able to raise additional assets and may be unable to fulfill their obligations. With peer groups it’s important to understand an individual organization’s unique goals and needs and select a peer group that is most similar.

While peer universes are of interest, they do not have some of the qualities that make a good benchmark as defined in *Characteristics of a Good Benchmark* table on page 2. They are not investable and they are not specified in advance. Survivor bias is an important drawback to peer groups that fiduciaries should understand. This occurs when poor performing constituents drop out of a universe and their performance is no longer represented in the peer universe. This causes an upward bias and overestimation of the performance of the universe. At the individual manager level, it is common for poorly performing mutual funds to be merged with a more successful one, thus skewing the returns of the peer group upward.

## Total Portfolio Benchmarking

Total portfolio benchmarks assist fiduciaries in understanding performance in relation to the established goals and mission of the organization as stated in the investment policy statement (IPS). They help to answer important questions such as: Are we making good decisions? Where should we be spending more time? How do we compare to our peers?

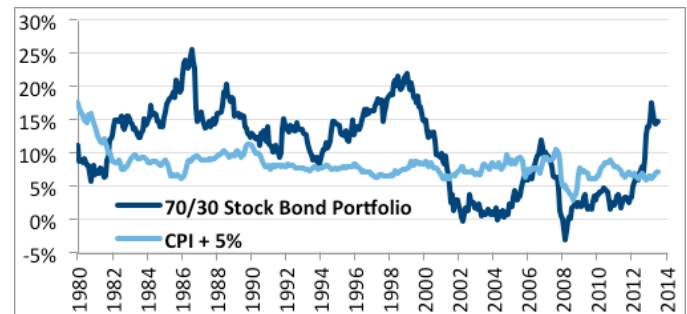
Perhaps the most relevant total portfolio benchmark is a goals-based benchmark that reflects the absolute return target for the organization. This is the return objective that is needed to sustain the organization's mission going forward. It should be a primary consideration for fiduciaries as it measures whether the organization has been able to sustain its charitable purpose. It focuses on supporting the mission while preserving the real value of the portfolio net of inflation.

**Investment Return Objective = Distribution/Payout + Fees + Inflation**

**Example: Net (of fees) investment Return = CPI + 5%**

An absolute return benchmark provides a means of measuring the spending goals of the organization versus portfolio performance. If the long-term goals of the organization are not being met, relative portfolio performance versus a market benchmark becomes less relevant. Organizations with a distribution/payout based objective might consider using absolute return benchmarks to focus the evaluation on whether the long-term goals and mission of the organization are being met. It's important to keep in mind that an absolute return benchmark is mission-based and does not reflect how the overall market has performed. Thus, it is not a relevant benchmark for manager evaluation.

**Rolling 5 Year Returns**  
**70% S&P 500/Barclays Aggregate vs. CPI +5%**



Consider a simple 70% S&P 500 and 30% Barclays Aggregate relative benchmark that has underperformed an absolute return policy benchmark of CPI + 5% in the past decade. The same portfolio would have likely outperformed the absolute return benchmark from 1982-2001. There may be periods when an absolute return benchmark is difficult to achieve; thus, a long-term focus is necessary.

### Constructing a Policy Benchmark for a Diversified Portfolio

At the total portfolio level, market benchmarks are passive representations of the investment process that represent the risk and return expectations of the institution. When benchmarking against the market, it may be useful to use a simple market benchmark as well as a blended benchmark that comprises the asset classes represented in the portfolio. This allows for evaluation of how the broad market has performed (simple benchmark) as well as how the active management and tactical positioning of the portfolio (blended benchmark) affected the portfolio's returns over a given time period.

Market benchmarks allow fiduciaries to evaluate how an investment program is doing relative to the overall market and judge how an external investment advisor or consultant's recommendations are adding value. A simple market benchmark denotes the overall investment objective of the portfolio and is sometimes referred to as a "naïve benchmark." For a portfolio that is comprised of roughly 70% equities and 30% fixed income, the benchmark may be 70% S&P 500 and 30% Barclays Aggregate. For a global portfolio, a more appropriate benchmark may be 70% MSCI ACWI and 30% Barclays Aggregate.

Alternatively, a more complex policy benchmark blends the strategic asset allocation targets from the IPS and includes the asset classes comprised in the portfolio. This is sometimes referred to as the policy portfolio. It provides the framework for measuring portfolio results relative to the risk-adjusted return objectives stated within the IPS. A well-diversified investment portfolio should meet the long-term risk/return objectives of the organization and is the result of asset allocation analysis which incorporates long-term strategic targets for each asset class based on capital market assumptions. Forward-looking capital market assumptions include expected risk and return, as well as correlation, and are integral to properly diversifying a portfolio to achieve maximum return given an acceptable level of risk. Once the strategic asset allocation targets are set, a policy benchmark can be created and incorporated into the IPS that blends the relevant indices with the strategic targets for each asset class. The use of a properly constructed and clearly defined policy benchmark will allow fiduciaries to view investment performance results in the correct, relative context and measure the progress accordingly.

The below sample "Exhibit A – Portfolio Guidelines" illustrates how benchmarks can be incorporated into the IPS. The stated policy benchmark blends the broad asset class targets and their appropriate indices. This policy benchmark can be constructed to be more granular and include sub-asset classes, such as high yield fixed income, if desired. In addition, the spending policy benchmark is included to represent the absolute return investment objective of a non-profit organization with a 5% spending policy. Finally, indices and peer groups are specified at the asset class level for performance measurement at the underlying manager level. Organizations should consult their investment advisor to help construct a customized benchmark most appropriate for their investment program.

## EXHIBIT A – PORTFOLIO GUIDELINES

Asset Class	Target	Range	Benchmark	Morningstar Peer Group
<b>TOTAL EQUITY</b>	<b>65%</b>	<b>50-80%</b>		
<b>DOMESTIC</b>	<b>45%</b>	<b>20-80%</b>		
Large Cap	38%	20-80%	S&P 500	Large-Cap Blend Equity
Mid Cap	0%	0-25%	Russell Mid Cap	Mid-Cap Equity
Small Cap	7%	0-25%	Russell 2000	Small-Cap Equity
US REITs	0%	0-10%	NAREIT Equity	Real Estate
<b>INTERNATIONAL</b>	<b>20%</b>	<b>0-50%</b>		
Developed	15%	0-40%	MSCI EAFE	Foreign Large Blend
Emerging	5%	0-20%	MSCI Emerging Markets	Diversified Emerging Markets
<b>FIXED INCOME</b>	<b>15%</b>	<b>5-40%</b>		
Core Investment Grade	5%	0-40%	Barclays Aggregate	Intermediate-Term Bond
High Yield	5%	0-10%	Barclays US Corporate High Yield	High Yield Bond
International Developed	0%	0-10%	JPM GBI Global Bond (hedged)	World Bond
International Emerging	5%	0-10%	JPM GBI – EM Global Diversified (un-hedged)	Emerging Markets Bond
<b>ALTERNATIVES</b>	<b>20%</b>	<b>0-30%</b>		
Diversified Hedge Funds	7%	0-20%	HFRI FoF: Diversified	Multialternative
Hedged Equity	10%	0-20%	HFRI FoF: Strategic	Long/Short Equity
Private Equity	3%	0-10%	Cambridge Associates US Private Equity	
Commodities	0%	0-15%	DJ UBS Commodity Index	Commodities
<b>CASH</b>	<b>0%</b>	<b>0-25%</b>		

Policy Benchmark	
38%	S&P 500
7%	Russell 2000
20%	MSCI All Country World Index (ACWI) Ex US
15%	Barclays US Aggregate
20%	HFRI Fund of Funds Diversified
<b>100%</b>	

Spending Policy Benchmark	
Distribution	5.0%
Expenses	0.8%
Inflation Estimate	2.0%
	7.8%

Source: SunTrust Foundations and Endowments Specialty Practice

### Conclusion

Benchmarks are a valuable tool in the performance evaluation process. To assist fiduciaries in fulfilling their obligation to monitor and evaluate performance, they should focus on measuring what matters:

- Establish and monitor relevant benchmarks to understand the trend of performance and how the portfolio is tracking to long-term targets.
- Don't overemphasize the most recent monthly or quarterly data. Instead focus on a full market cycle of 5 years.
- Consider an absolute return policy benchmark, knowing that it may require a long market cycle to achieve.
- Consult peer group comparisons for greater perspective.

Measuring what matters and using a combination of benchmarks will likely give fiduciaries the greatest perspective to answer the important question of "How are we doing?"

***“Games are won by players who focus on the playing field –  
not by those whose eyes are glued to the scoreboard.”***

**– Warren Buffett**

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<sup>1</sup> As of September 30, 2016

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