

Benchmarks From a Consultant's Perspective

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One of the key roles that consultants play in pension asset management is to assist plan sponsors in the quantitative evaluation of the performance results of their investment managers. Industry standards, as set by the AIMR (Association for Investment Management and Research) and supported by the Pension Investment Association of Canada (PIAC) recommend the use of benchmarks in the performance evaluation of investment managers.

As a result of industry acceptance of the need for suitable benchmarks, in the U.S. the number of benchmarks available for performance evaluation has proliferated. With the introduction of the TSE 100 Canadian investors will also have some choice as to the benchmark selected for quantitatively evaluating their investment managers.

What Is a Benchmark?

Perhaps the best analogy for describing a manager's benchmark is that it represents the manager's preferred "fishing hole" or area of expertise. Similar to a fisherman who has a choice of what part of the lake in which to cast line, the manager also has a preferred set of securities from which a model portfolio is constructed for clients. Hence, a benchmark portfolio is a performance index designed from the universe of securities from which the manager considers selecting stocks.

Choosing an appropriate benchmark or "bogey" for the manager to be measured against assists the plan sponsor in determining if a manager is skilled at actively managing the investment activities and, therefore, deserving of receiving active management fees.

Designing An Appropriate Benchmark

Consultants Bailey, Richards and Tierney suggest that the following characteristics describe an effective benchmark¹:

Unambiguous

The securities and their weights comprising the benchmark are clearly delineated;

Investable

The benchmark can be effectively and efficiently replicated for passive management;

Measurable

Benchmark return can be easily calculated;

Appropriate

The benchmark should be reflective of the universe of securities the manager closely follows.

Specified

The benchmark is constructed in advance of the evaluation period.

Canadian equity money managers (excluding small cap managers) have traditionally been "benchmarked" against the TSE 300 Total Return Index. However, based on the characteristics listed above, the TSE 300 is a flawed and unsuitable benchmark for a number of institutional money managers.

The TSE 300 cannot be easily replicated for passive management. Hence, comparing the "actual" returns of a money manager against the total returns of the TSE 300 is somewhat of an "apples and oranges" comparison.

For most institutional investors the TSE 300 is an unsuitable benchmark. These managers tend to have a "fishing hole" comprising the top 100 to 150 securities based on market float (i.e. they are large cap managers). For such investors, the TSE 100 would be a more appropriate benchmark against which to measure and evaluate performance.

A Benchmark Performance Reality Check

Poor benchmark performance comparisons can create noise in the performance evaluation process, serving to obscure the true signal of manager results. A clear reality check of the importance of measuring institutional fund management against an appropriate benchmark could be illustrated by the stock market results for the one year ending June 30, 1993.

For example, in the exhibit below we see that Big Cap Investment Limited, (an active large-capitalization institutional fund manager) having a portfolio consisting of many of the largest 100 stocks of the TSE 300, earned a return of 19.5% for the year ending June 1993. If compared against the broad

market TSE 300 Index, Big Cap's 130 basis point underperformance would not seem to support active management skills. However, it should be noted that the 20.8% total return of the TSE 300 is not entirely reflective of the return of only large cap stocks, and, in fact, could be partially accounted for in the extraordinary returns from the small capitalized stock portion of the broad index.

It is more appropriate to evaluate Big Cap's performance by measuring against the total return of the TSE 100 Index, which more closely resembles the universe of stocks in which this institutional fund manager could invest. Comparing Big Cap's 19.5% return against the 18.2% return of the more appropriate index, one can conclude that the manager did demonstrate value added skills in his area of expertise — large market capitalization stocks. We conclude that the true "fishing hole" for Big Cap Investment Limited is better represented by the TSE 100 Index and not the TSE 300.

Improve Communications

One of the major objectives in properly evaluating performance is to eliminate unwanted surprises

in the manager monitoring process and consequently improve client-manager-consultant communications. In order to achieve this task, the information evaluated must be relevant. The TSE 100 Index satisfies this criteria for a distinct group of institutional money managers, and should assist sponsors, consultants and managers in improving communications and further developing good relationships.

**Exhibit 1: Value Added Results
One Year Ending June 1993**

Big Cap	19.5%	Big Cap	19.5%
TSE 300	<u>20.8%</u>	TSE 100	<u>18.2%</u>
Value Added	-1.3%	Value Added	1.3%

¹ See "Benchmark Portfolios and the Manager/Plan Sponsor Relationship" in Current Topics in Investment Management, 1990 Harper & Row.