Investment Management for the Nonprofit Industry: Benchmarking

Lynx Investment Advisory is pleased to summarize a series of guidelines associated with portfolio benchmarking. This review is designed to assist nonprofit institutions with performance measurement.

There are three popular ways in which an investment committee might measure the return generated by their portfolio. The first is in absolute terms or the absolute performance percentage, the second might be a comparison between the portfolio performance and its policy portfolio (based on target allocations in the investment policy statement (IPS)), while the third measure is a comparative analysis of the portfolio performance against a composite benchmark of the underlying investments.

Return: Absolute Measure

- An absolute return provides a complete snapshot of the portfolio's performance within a designated time frame. It measures the percent change in the value of a portfolio over a defined historical period.
- For those managers or investment officers utilizing the absolute return approach, typically a benchmark is not used, or in other words, any excess return is considered alpha generated and is believed to represent the return from active management or skill.
- In cases were an organization/nonprofit has selected the absolute return approach, Lynx recommends having available a CPI + 3% reference rate as a guideline in order to help maintain a focus on the organization's long-term/perpetual sustainability. However, an organization should understand their own inflation rate, which might be very different from published CPI data.
- Lynx does not rely on the absolute return approach for the portfolio as a whole, nor does it feel it is a fair representation of a portfolio's performance as it does not take in to account the difference between the beta and alpha contribution both at the underlying manager and total portfolio level. In rare cases will Lynx condone an absolute result for an individual investment; in these instances the lack of a benchmark is typically due to the nature of the underlying investments and the absences of an accurate evaluation measure (e.g. an esoteric, niche private equity or venture capital fund).
- In the case of an underlying hedge fund investment, not only do many of managers prefer the absolute return approach, but there are no market indices to track many of these strategies, thus Lynx will submit to the use of a peer universe, such as Hedge Fund Research Indices (HFRI) with its comparative analysis.

Return: Portfolio vs. Policy Benchmark

- Lynx believes policy benchmarks are a suitable way for fiduciaries to understand how their investment program is performing as it relates to the organization's established goals and mission. It is a useful tool in determining the effectiveness of the board/investment team's decision making process and how well the investment policy objectives meet the organization's needs (found in the investment policy statement (IPS)).

- The policy benchmark should be goals based. The investment return objective should incorporate the organization's long-term spending/accumulation goals, while preserving the real value of the portfolio net of inflation. The benchmark should provide the framework for measuring portfolio results relative to the risk-adjusted return objectives stated within the IPS.
- The policy benchmark should be a blended composition of simple market benchmarks comprising the target asset classes as stated in the IPS. By constructing the benchmark in this way, the board/investment team is able to evaluate whether their portfolio meets/continues to meet the long-term risk/return objectives of the organization and the efficacy of their asset allocation and tactical tilts in terms of long-term strategic targets.
- It is important to remember that a policy benchmark is mission-based and thus does not reflect how the overall market has performed. It is also essential to keep in mind that if the long-term goals of the nonprofit are not being met, relative performance against a market benchmark becomes less significant.

Return: Portfolio vs. Composite Benchmarks

Characteristics of a Good Market Benchmark

Unambiguous – The benchmark should be clearly understood by all parties involved in the investment program.

Investable – The benchmark should represent an investable alternative; the trustees could choose to hold the benchmark rather than hire individual managers.

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: The Research Foundation of CFA Institute 2011

- A market benchmark should reflect the investment objectives, philosophy, and the fund manager's attitude to risk.
- An accurate market benchmark must provide a valid reference for comparison of a specific investment portfolio. It is important to select a benchmark that closely resembles policy constraints and management practice in terms of investment style, geography, sector, security type, duration, maturity range, and credit quality, to name a few.

- There are many indices available to track equity and fixed income asset classes across all markets globally. Lynx takes extra care to ensure the correct benchmark is used for each asset class and individual manager. In most cases the benchmark used by the underlying manager is the ideal option, but on occasion it is important to review and challenge a manager's selection. As an example, Lynx will use the S&P Indices over the Russell Indices. In general, the S&P Indices are harder to beat than their Russell counterparts due their different rebalancing procedures. Changes to the Russell indices are made annually, while the S&P makes their changes as needed. Given that the Russell reconstitution is done mid-year, it is widely known in advance which companies will be added or removed from the benchmark and therefore, those funds that track the index are forced to trade those securities simultaneously, while active managers are more easily able to front-run the funds, allowing for a stronger track record against a Russell benchmark.
- It is important to keep in mind when selecting a benchmark, that relative risk measures such as excess return, tracking error, and beta are based in part on the performance of a benchmark, therefore if the benchmark is not a fair representation of the portfolio, these risk measures will fail to provide useful information.

Date: February 2017