Seed Weekly

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Benchmarks

Benchmarks in the investment industry is not a new concept. The idea of a benchmark dates all the way back to 1884. In an effort to measure the performance of stock markets, instead of individual shares, Charles Henry Dow developed the first Dow Jones index by taking the average of the prices of 11 railroad stocks. This average number was published daily, providing investors with a regularly updated indicator of the market.

Over the years, the impact of benchmarks has extended past their initial role as an indicator of market performance. Benchmarks have become an integral part of investment management, impacting active management of portfolios, asset allocations and performance measurement. Benchmarks are mainly used for the following purposes:

- Creating Index Tracker funds for investors who want passive exposure to certain asset classes
- Performance measurement of active managers
- As a proxy for certain asset classes during the portfolio construction process

Many active investors use the underlying instruments of benchmark index as their starting point when constructing their portfolios. Portfolio managers then deviate from underlying instrument weights of the index if they are convinced that a particular stock is more or less attractive than the market as a whole. Fund managers often make use of benchmarks to assess the asset allocation of the portfolio and the desired risk and possible return outcome of a specific portfolio. Benchmarks are then usually created using unmanaged indices, exchange-traded funds (ETF) or unit trust fund categories to represent each asset class.

Some managers are more than happy just to match a certain benchmark's performance, while others work to beat them. While beating a benchmark can make investors happy, providing too much of an incentive to do so can force a manager to take unnecessary risk within a portfolio. By comparing their portfolio to the benchmark, asset managers can determine the amount of risk they are taking relative to the index to achieve their fund's performance. The additional risk that active managers are taking to attain the performance in excess of the benchmark is referred to as active risk.

When evaluating the performance of any investment, it is important to compare it against an appropriate benchmark. Common benchmark indices include the JSE ALSI, JSE Top 40, ALBI, SA Listed Property, etc. Even competitor funds are used as benchmarks. Setting a benchmark can help an investor communicate with their portfolio manager as to what they are hoping to achieve with their investment, enabling the portfolio manager to make decisions with the investor's objectives in mind. As an investor, the first step in selecting a benchmark is determining your risk profile. There are many factors which determine your risk profile, including age, investment horizon and other financial resources, such as cash reserves. An investor's benchmark should always reflect the total amount of risk he or she is willing to take.

The next step is to decide on the overall asset allocation that reflects your risk profile as closely as possible. As most investors should have a well-diversified portfolio, the asset allocation of the benchmark should include multiple asset classes, for example local equities, local property and local fixed income instruments, as well as the corresponding offshore asset classes. After the investor has decided on a specific benchmark, he or she can use it to evaluate their portfolio. At this stage you may discover that you are taking too much or not enough risk. Additionally, the benchmark provides a guideline for occasionally rebalancing your portfolio's asset allocation to help manage the risk exposure of your investment.

Kind regards,

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