



PORTFOLIO PERFORMANCE...

The Need for the Use of Appropriate Benchmarks

Usually an area of contention between fund managers and investors is determining how well the manager has performed. If at the end of last year, your portfolio returned 20%, how do you know whether that is a good or poor performance? The best way of assessing performance is to benchmark. A benchmark is an unmanaged group of securities or a measurable index whose performance is used as a standard to measure investment performance.

Benchmarks are essential tools in the investment management process, not only for individual investors assessing performance but also for fund managers, who are often partly compensated on the basis of their performance.

However, choosing an appropriate benchmark is more important to the investment management process than using a benchmark as a reference point. The benchmark must be relevant in assessing the performance of a portfolio and it must complement the investor's goals and objectives.

Characteristics of a Benchmark

A "one size fits all" basis for measurement is a misleading tag in evaluating performance and more importantly, it is inappropriate in the investment world. An appropriate benchmark should have the following characteristics:

1. Unambiguous: The weights of the investments that make up the benchmark must be identifiable e.g. the percentage of equity and bonds used in the construction of the benchmark must be known
2. Measurable: It should be possible to calculate the return on the benchmark on a reasonably frequent basis, objectively and independent of the manager. For example, the return on the Nigerian Stock Exchange (NSE) All - Share Index is measured daily.
3. Appropriate: The benchmark should be consistent with the investor's investment goal. For instance, if an investor's goal is to preserve capital and earn some income, an appropriate benchmark would be the Treasury Bill rate which is best suited for comparing the performance of the investor's portfolio.
4. Specified in advance: The benchmark should be agreed by the investor and manager prior to the start of the investment. This is a critical decision that should be made from the inception of their relationship, as it would ultimately limit misunderstanding between both parties, with regard to performance.

Benchmarking Techniques

The following methods are used to evaluate portfolio performance:

- ***Indices***

The most common performance benchmark is the index - a pre-selected group of securities perceived to have some significant correlation to the overall performance of the stock market or a segment of the market. Examples of these are the NSE All - Share Index (Nigeria), Dow Jones Industrial Average (U.S.) and FTSE 100 Index (UK), amongst others.

A disadvantage of using indices as benchmarks is that the portfolio may not be an exact replica of the index (with the exception of index portfolios). More importantly, indices do not have transaction costs and exclude dividend payments in their computation of return. Consequently, a portfolio may under - perform or out - perform its benchmark because of the composition of the portfolio.

There are other forms of indices, which are not market related. An example of this is the Consumer Price Index (CPI), which is an inflation index/measure. In the case of the CPI, the portfolio components have no bearing on the basket of goods used to measure inflation but equity portfolios, in general, have a history or tendency to move in line with inflation trends over the long term.

Similarly, government determined fixed interest rate such as the Minimum Rediscount Rate (MRR) is also widely used as a benchmark for income portfolios. The MRR serves as a guideline for interest rate direction and, to the investor, assures a risk premium above the Treasury Bill rate. By definition, the MRR is more appropriate for portfolios that have short dated fixed income and money market instruments but will not be suitable as a benchmark for a long term growth portfolio with equity exposure.

- ***Peer Group***

A different method for benchmarking is to use peer-group measures - that is, to see how your portfolio/fund performs against those that have the same characteristics, e.g. objective and composition. Peer-group measurements are in some ways more authentic than indices because they average the performance of other actively managed funds, rather than the theoretical performance of an index. However, care should be taken in using this measure, as there are various portfolio types, which are structured based on various objectives and risk profiles. Thus investors should be mindful of comparing their portfolios with other portfolios that do not have the same objectives as theirs. So in measuring performance using peer group, the investor should use the same time period, portfolio composition and investment objectives as basis for comparison.

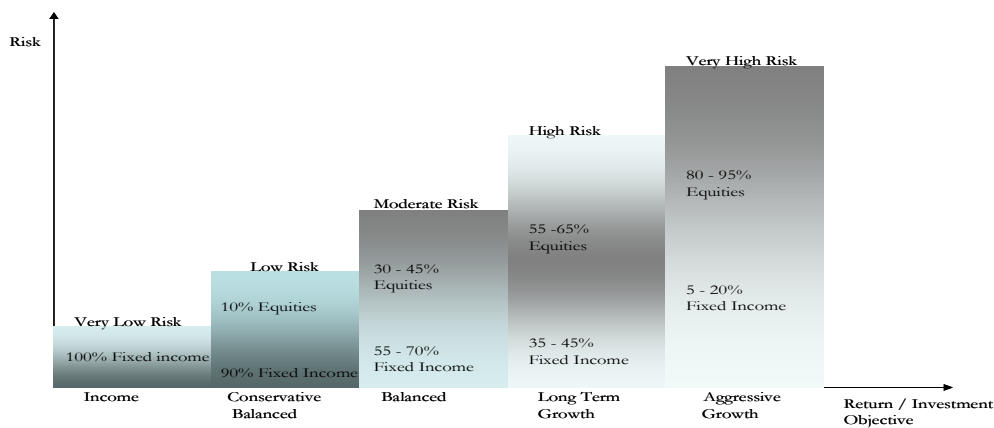
- ***Custom Benchmarks***

Customized benchmarks are designed to meet the specific objectives of a portfolio, given the portfolio's risk tolerance. For example, an investor with a moderate risk profile has an equal balance between the desire to generate capital growth and income. The resultant portfolio would be a blend of assets that follow an objective of long-term growth and assets that lend themselves to more stable but lower returns. Such a portfolio, typically, would have a strategic allocation of 35% - 45% in equities and 55% - 65% in fixed income. Now, if we use the NSE All - Share Index as a benchmark against this portfolio, it would not represent a good yardstick for comparison as the portfolio holds fixed income instruments, which do not form a part of the NSE All – Share Index. Therefore, to find an appropriate measure for this portfolio, a customized benchmark is designed which would capture returns from equity and fixed income instruments. For example, the customised benchmark could be a combination of the NSE, for equity allocation and the Treasury Bill Rate or Government Bond Index for the fixed income allocation, where such exists.

Investor's Objective and Risk Profile

An investor's objective and risk tolerance (i.e. the ability or willingness to endure temporary declines in the prices of investments for future possible gains), are the key determinants in structuring an investment portfolio. This is also true in choosing a benchmark.

Generally, investors fall within five broad risk profiles/portfolio objectives as shown below. As varied as investors' risk profiles are, so is the risk associated with various portfolios. Portfolio risk is the variability of expected returns or the probability of any outcome different from the one expected.



Customising Benchmarks to Suit Portfolio Objective and Risk Profile

Customising a benchmark for various portfolio objectives and risk profile would require a combination of the benchmarks of the individual asset classes that make up the portfolio. In other words, evaluating the performance of a diversified portfolio requires that the performance of each asset class within the portfolio is compared against a standard that is representative of its risk and reward. For example, a Long-term Growth portfolio would typically have an asset allocation of 55% - 65% equities and 35% - 45% fixed income. The appropriate benchmark for this portfolio would be a weighted performance of the NSE All - Share and the Nigerian Treasury Bills. Thus, a weighted average return of 46.69% for year 2003, for example, would be a more accurate benchmark for a long-term growth portfolio as it reflects the combined performance of both the equity and fixed income exposures.

This same exercise can be carried out for the other risk profiles by altering the asset allocation to reflect the objective of the portfolio. The table below shows benchmark historical returns for the five broad Naira based portfolios;

Benchmark Historical Returns							
	Risk Level	1999	2000	2001	2002	2003	Cumulative Returns
Aggressive Growth	5	-2.10%	46.30%	31.80%	12.20%	56.09%	230.6%
Long Term Growth	4	3.00%	38.50%	28.40%	13.80%	46.69%	205.8%
Balanced	3	9.40%	28.80%	24.30%	15.70%	34.94%	173.5%
Conservative Balanced	2	15.70%	19.10%	20.10%	17.60%	23.2%	139.8%
Income	1	18.30%	15.30%	18.40%	18.40%	18.50%	126.6%

From the above, it is important that investors choose appropriate benchmarks that suit their portfolio objectives. This would give a true and fair picture of their portfolio performance and the general competence of their investment managers. Given the choice between risk levels 4 and 5, an investor that chose risk level 5 was compensated by an extra return of 24.80% over the five year period for accepting a higher risk. It is, therefore, up to the investor to decide whether the incremental reward being offered is sufficient for the extra risk being taken.

Conclusion

A portfolio that mirrors a benchmark may not be enough in measuring a manager's performance because most investors expect positive return in a bullish or rising market but at least capital preservation in a bearish or declining market.

Beyond benchmarking therefore, an investor should consider:

1. Long-term performance of the manager. A steady performance over a long term period is a reliable measure of a manager's consistency in varying market conditions. The longer the track-record of the manager the more reliable would the assessment of the manager be.
2. Volatility – usually the higher the risk, the higher the return. Volatility is a good indicator for measuring the performance of the manager. An investment portfolio with high volatility suggests high risk, high return with high downside potential. Two portfolio managers may have the same annualised return over time, however, the risk taken by one portfolio manager may be higher than another portfolio manager. This point is illustrated below where Managers A and B have the same annualised return of 24.79% over 5 years on two separate portfolios but clearly Manager B has a higher variability of returns (also known as standard deviation), than Manager A and hence, portfolio A is considered to be a riskier portfolio than portfolio B.

FUND MANAGER	1999	2000	2001	2002	2003	ANNUALISED RETURN OVER TIME	STANDARD DEVIATION
A	17.67%	-23.59%	69.8%	-13.90%	130.19%	24.79%	64.01
B	14.27%	-2.18%	41.09%	10.08%	74.28%	24.79%	30.55

The combination of a manager's track record, style and appropriate benchmark computation will reduce distortions that arise from using stereotypical benchmarks and will give investors an accurate picture of the performance of their portfolio of investments. In instances where inappropriate benchmarks are used, considerable over- or under-estimation of performance may be generated resulting in significant errors in the final performance of the portfolio relative to the investment objective.

Finally, set your benchmark depending on your investment objective and risk profile, **and make your overriding goal consistency in returns overtime**. Benchmarks would not increase your portfolio in and of themselves, but they will help you make sure your investments are keeping up with your expectations. **Do not forget also that the process of investing is like a marathon, so seek the discipline not to be swayed by short term considerations. As is the case in a marathon, it is not your relative position at the first 100 meters; it is whether you have the right strategy to complete the race in a good position!**

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