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Consider benchmarks in building any portfolio

Investing requires decisions to be made within an ever-changing environment. The general economy, interest rates, corporate earnings, investor sentiment, Federal Reserve Board policy, housing starts, retail sales, the strength of the dollar, and productivity are just a few of the regularly watched indicators whose only constant is they will continually change.

A seemingly endless array of factors influences the investment markets and, consequently, your portfolio. How do you make good investment decisions when what you're deciding on is constantly in flux? Where do you begin?

First, ongoing portfolio management needs to be based on the framework defined by your personal investment policy. And that policy should quantify the expectations and parameters of your investment portfolio.

For example, what is the purpose of the portfolio? An annual stream of income or long-term capital appreciation? Or perhaps a combination of both. What is the maximum and minimum equity exposure desired?

What percentage of your investments should remain in stable, short term vehicles, such as money market funds? Are there any types of securities, industry sectors, or asset classes you wish to limit in your portfolio?

Your investment policy provides the foundation upon which future portfolio management decisions will be based. When built upon a defined investment policy, a portfolio becomes more than just a random collection of stocks, bonds, mutual funds, or other investments. Assets become building blocks designed to accomplish specific goals, and selections are made because they match defined objectives in the investment policy. The focus of the portfolio becomes clear.

But that's just the beginning.

As noted previously, the investment environment is truly dynamic. Consequently, successful portfolio management needs to discern which changes present possible opportunity or concern and which are merely distractions.

Proper management identifies and reduces the number of external variables potentially affecting portfolio assets, while controlling the impact of those variables that can't be eliminated.

To accomplish this, appropriate points of reference must be defined for the portfolio and used as comparisons. Using comparative benchmarks provides objectivity in portfolio decision-making and adds a degree of discipline. The saying, "It's all relative" is particularly true for investing.

As an illustration, I jointly ask the question with my clients, "Compared to what?" For example, "Is XYZ investment performing well?" Compared to what? The Standard & Poor's 500 index? Industry peers? Last year's performance? Other investments in the portfolio?

It's important to know what criteria you are using when making critical judgements. Without benchmarks, decision-making is reduced to guessing, choices become reactionary and the achievement of long-term objectives is left to chance.

Suppose your large-cap stocks were down 10 percent from their 52-week highs, as of the end of September. Sad day? No, consider yourself fortunate because more than 61% of all S&P 500 stocks were off their 52-week zenith by 20 percent or more. In fact, nearly a third of the entire S & P 500 universe declined 30 percent or more from their one-year high water marks as of the end of the third quarter.

Relatively speaking, your equity portfolio was unscathed.

Such comparisons are particularly important when assessing the efficiency and effectiveness of your overall portfolio structure. Decisions regarding the management of an investment portfolio typically involve three key interrelated factors-- risk, return and cost. Collectively, these factors define a portfolio's performance.

Again, relative measures are critical in accurately comparing a portfolio's risk, return and cost. Several standard portfolio measurements can be useful in your portfolio or fund decision-making process.

Some measures are relatively simple and easy to obtain or calculate. Others are more complex and best delegated to an investment professional with supporting data and software.

One often-used statistical measure of risk is standard deviation. This compares a portfolio's variability in return versus its average of returns. A portfolio with a high standard deviation implies more risk because the investor is less certain of subsequent returns.

As a simple example, suppose two portfolios each had a 10 percent average annual return. Portfolio A achieved this average with annual returns of zero and 20 percent, while Portfolio B had returns of 8 percent and 12 percent. Portfolio A's standard deviation would be notably higher. This high deviation is not necessarily bad because variability can also have an upside.

But if these two portfolios continue to have a similar average returns for similar timeframes, Portfolio B is a better choice because the investors in Portfolio A are not being rewarded for their increased risk.

Another benchmark that compares relative risk to return is a portfolio's beta coefficient, often simply referred to as "beta". While standard deviation measures a portfolio's range of returns versus its average of returns (variability), beta compares it's return with the return of a comparable market index (volatility), such as the S & P 500 index or the Lehman Brothers Government/ Corporate Bond Index.

A beta of "1" indicates portfolio volatility is equivalent to the benchmark index appropriate for that portfolio. A portfolio with a beta higher than the comparable index (higher than 1) but with annual returns consistently below index level indicates the investor is again not being adequately compensated for the additional risk.

Other measures used in assessing relative portfolio performance emphasize comparative cost, such as expense ratio and tax efficiency. For instance, suppose Portfolio A's management style results in hefty taxable gains and has operating expenses that are 30 percent higher than Portfolio B.

Even if A's gross return significantly exceeds B, a comparison of returns net of cost could indicate B is the better performer.

These are just a few of the comparative measures that can be used to effectively monitor and improve your portfolio's relative performance. Understanding these benchmarks will provide solid points of reference and add discipline to your portfolio decision-making process.

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