

## What Are Benchmarks?

An investment benchmark is a point of reference or standard by which to evaluate and assess the performance of a security or investment manager. Thousands of indices have been created and used for this purpose. These indices often measure hundreds or thousands of securities representing some aspect (sector or asset class) of the total market. For instance, in the equity market, the S&P 500 is one of the most popular large cap stock benchmarks. It is made up of 500 of the largest U.S. publicly traded companies and is frequently used to gauge the performance of the U.S. large-cap equity asset class.



## How To Select Benchmarks

When evaluating the performance of an investment, it is important to compare it against an appropriate benchmark. Investors should choose benchmarks that most closely represent the asset classes they want to look at, such as U.S. large cap stocks or international bonds. To be chosen as a suitable benchmark, both the benchmark and the asset class to be compared must have similar underlying constituents. For example, benchmarking a U.S. large cap mutual fund against a global stock market index may not be an appropriate way of measuring that fund's performance because the investment security holdings in the global market are tied to overseas economies and will likely behave quite differently from investment security holdings in the domestic market.

## The Process of Selecting Benchmarks for an Asset Class

1. First choose the specific asset class that you want to benchmark. When selecting benchmarks, look to investment performance reporting vendors who can provide access to a vast database of benchmarks and performance indices.
2. After reviewing the data from your performance reporting vendor, identify three to five of the indices most commonly used for the selected asset class. The performance reporting vendor may be able to provide proprietary statistics about their current users on the two to three most commonly used benchmarks for this specific asset class. Identify the benchmark most commonly used by the performance reporting vendor for the specific asset class.
3. Review the indices used by investment managers for the specific asset class to identify the one or two most commonly used benchmarks.
4. Compare the benchmarks used by the performance reporting vendor with the benchmarks used by current investment managers. Choose the best fitting benchmark for the asset class based on the data gathered.

## Benchmark Monitoring Criteria

Fi360 publishes *Prudent Practices for Investment Advisors*, a handbook which defines a global fiduciary standard of excellence consisting of four phases: Organize, Formalize, Implement, and Monitor. In the Monitor section, Practice 4.1 describes the importance of periodically comparing investment manager performance to a benchmark or other appropriate index. To adhere to these best practices, review your investment benchmarks annually and make changes as needed. Although they should be reviewed frequently, you may find that changes to your selected benchmarks might be rare.

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