IMAP Independent Thought Podcast

Episode 34: Key Considerations when Benchmarking Managed Accounts

Julie Ballard (S&P Dow Jones Indices) and **Tim Farrelly (Farrelly's Investment Strategies)** discuss:

- Benchmarking managed accounts in Australia today
- Specific challenges facing advisers when reviewing managed account performance
- How can advisers approach benchmarking for portfolios with allocations to alternatives?
- How should advisers balance performance with risk management?

Hosted by Emily Barlow (Perpetual Private)

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Emily Barlow - Perpetual Private:

Hello and welcome to episode 34 of the IMAP Independent Thought series, a podcast dedicated to helping managed account professionals stay up to date with views from a range of investment and advice experts.

My name is Emily Barlow and I'm an investment director at Perpetual and your podcast host.

Today I'm joined by Julie Ballard and Tim Farley.

Julie is Director of Channel Management at S&P Dow Jones Indices, working with wealth management firms across Australia and New Zealand promoting S&P's indices and services.

Tim is the founder of Farley's Investment Strategy and Independent Specialist Asset Allocation Research Service for wealth management firms, also across Australia and New Zealand.

In today's episode, we'll be discussing benchmarking. You may not think this is the most exciting topic, however, with our guest today, I hope we can convince you.

Otherwise, we'll be talking about how benchmarking is currently applied in managed accounts, its importance, and we'll also discuss some of the issues that are impacting client outcomes and perhaps how we might begin to address some of those issues.

So let's get started. Julie, can you kick us off by giving our listeners an overview of where we're at with benchmarking managed accounts in Australia today?

Julie Ballard - S&P Dow Jones Indices:

Thank you Emily and Tim, great to see you again. We seem to be a bit of a double act on this topic. There's two of us, at least, who think it's exciting enough to have multiple discussions around benchmarking. I would say benchmarking or manage account portfolios in Australia is evolving.

Currently, there is not a standardised approach to the selection of benchmarks, particularly for multi-asset portfolios where we see a wide range of different benchmarks being utilized even for portfolios in the same category.

For instance, in the multi-asset category of IMAP's annual managed account awards submissions were requested to include data in a balanced portfolio. This year across the 20+ submissions, there were 10 different benchmarks being used for what the portfolio managers considered to be their balanced portfolio.

These benchmarks were a mixture of RBA plus CPI plus and PR indices. Only one you could say was market linked.

Julie Ballard - S&P Dow Jones Indices:

As you can imagine, this makes it really difficult to assess portfolios when there are so many different goalposts being used for what should essentially be the same playing field.

This situation is not unique to Australia, nor is it limited to managed accounts in the UK. Asset risk consultants, also known as ARC conducted research where they collected performance data from 140 wealth managers covering around 340,000 investment portfolios.

They found that 94% of these managers claim to deliver first quartile performance, and we don't need to be a math genius to work out. 94% does not equate to a quartile. So just about all of the managers were claiming top quartile returns.

According to ARC, the managers were able to do so by choosing different criteria to suit their needs. I think it's also worth noting the CFA Institute publishes resources on benchmarking and their GIPS standards. That's their global investment performance standards set out best practice guidelines, which are used by institutional investors.

Julie Ballard - S&P Dow Jones Indices:

Market link benchmarks do meet many of the features set out by the CFA for selecting what they term as “appropriate and valid benchmarks”. The peer and CPI benchmarks, which are widely used in managed accounts, are not necessarily recommended by the CFA if there are better options such as market link benchmarks available.

Why is that? Well, according to the CFA an objective to outperform the returns of the median fund in a peer group universe is assessed as "poor".

And that's due to the fact that it is ambiguous and also not actionable, because the median fund is not known, and CPI plus X percent is considered quote unquote "bad" as it's not actionable as well.

So we're seeing a wide range of benchmarks being used for portfolios you would consider to be in the same category, whether it is balance growth, conservative, etcetera. And these are not necessarily in line with the CFA standards as well.

Emily Barlow - Perpetual Private:

Thanks, Julie. So you've certainly addressed the breadth in terms of the benchmarking views. Tim, it'd be great to get your thoughts on the specific challenges facing advisors when they're reviewing performance.

Tim Farley - Farley's Investment Strategy:

I guess there's two issues. One, it depends on what the advisor is doing. If the advisor is basically reviewing performance of an outsourced model that's one issue. It's another issue when a lot of advisors or advisory groups run their own managed account structure and they're reviewing their own performance.

And so there's two kind of different functions there.

So to Julie's point, if I'm in a position where as an advisor I'm saying, look, I have decided to outsource the investment management function, and I'm looking amongst the various providers to try and understand who has given good returns historically, then it becomes incredibly difficult for all of the reasons that Julie mentioned.

Everyone's got their own benchmark. Do they fudging the figures, or fudging the benchmark to make themselves look good, picking the time period that makes them look good.

Tim Farley - Farley's Investment Strategy:

So in that respect, it would be very useful, I think, and this would be a point that Julie's made in in other forums, and I think it's a very good one to have at least a consistent set of benchmarks so that if we're comparing managers versus benchmarks, we kind of know that we're actually at least comparing "like with like", that immediately creates another set of issues though, which is do we just compare them to our own benchmarks?

Say I've got a portfolio where I have a neutral portfolio that is say 40% Australian equities, 20% international. Someone else has 40% international, 20% Australia. We have different benchmarks. We both can outperform our benchmarks and have very different returns.

So the next challenge with the advisors, (in that role of who do I choose as my outsource provider?) is to try and understand what is the benchmark, how valid is it, and what am I actually learning from this?

Tim Farley - Farley's Investment Strategy:

One of the things we do know and a lot of S&P's work has shown this over and over again, is that past performance is actually a really poor guide to future returns. And yet you know, the pressure is coming, well, you've got to review your under-performing options as Julie mentioned.

So that's going to be another real challenge for advisors in that if I'm in a strategy, which let's say is a defensive strategy, where the manager is much more likely to take defensive positions and their view is in the long term, I'm going to get persistent under-performance in bull markets, but I'll really outperform in bear markets and give a better client experience.

Well, how do I measure that? And if the actual intention of the strategy is to outperform in the long term, by particularly by avoiding bear markets, well, you know, we've now been 14 years or 15 years without a proper bear market, you know?

Tim Farley - Farley's Investment Strategy:

And, yes, I know Covid was deep, but it was so quick that to me that it wasn't a real bear market. It was a blip. And so if that's your strategy, well now what do you do? So it's the challenge for advisors when many are trying to understand what is the manager's strategy?

Are their returns consistent with that strategy when measured against a meaningful benchmark?

Now the other approach, which people often use is "let's use peer groups and see how are we going versus other people?". Well, the ranges in some of those peer groups can be huge, as anyone whose neutral allocation is between 60 and 40% gets put in the same group.

Well, let me tell you, someone whose neutral position is 58% is going to do a whole lot better over most time periods than someone whose setting is 42%.

Tim Farley - Farley's Investment Strategy:

But they all get lumped in together. So again, the advisors need to understand what's going on and make that challenge go to the other position, which is to say, "what if I am running my own managed account program?" There's a lot of advisory groups who do.

Then you've got to really understand - what am I trying to achieve with these benchmarks? And there's things that I need to tell my clients.

There are things that I need to tell the advisors in my group, and there are things I need to understand myself. Where am I making good decisions? Where am I making bad decisions?

How can I improve which aren't necessarily of interest or relevance to the other parties? So a major challenge is "what are we actually trying to achieve with all of this?" So it's, it's not without difficulties. In this whole thing, even we are so far away from having this right now, but even knowing what is right is pretty hard.

Emily Barlow - Perpetual Private:

Yes, very good points. And certainly, there are asset classes that can vary significantly. Which brings me to my next question to you Julie.

Julie Ballard - S&P Dow Jones Indices:

Actually, before we move on can I make a comment adding to Tim's reference about our research, he was referring to Spiva S&P Indices versus "Active Scorecard", which regularly reports on a percentage of active funds under performing the

relevant index benchmark. And we do this for various regions around the world. In our mid-year SPIVA, the global average under performance rate of local equity actively managed funds was just under 65% over one year increasing to around 85% under performance over 10 years.

So, what that is saying is over 10 years, 85% of actively managed local equity funds were not beating their relevant market link index. These figures were higher again for international equities. If we were to extend these results to implications for benchmarks based on peer averages, peer category benchmarks have historically provided a lower return hurdle than market linked benchmarks.

The performance outcome of different benchmarks can vary quite significantly. Take for example, a simplified balanced portfolio where we have 50% in Aussie equities and 50% in fixed interest.

We looked at it from a cumulative 10-year perspective, and the performance of the market link benchmark would have provided the highest performance result followed by the peer benchmark, which was below that by about 5%.

And a CPI plus 3% benchmark would have been the lowest at around 25% below the market linked result. I know this is based on historical data, but it does illustrate how benchmarks can provide very different outcomes.

Tim Farley - Farley's Investment Strategy:

In a bear market that changes dramatically, that completely flips on its head.

Julie Ballard - S&P Dow Jones Indices:

That's true. We have been in pretty much an extended bull market, but we've been doing SPIVA for the last 20 years and we do have SPIVA data, which dispels the myth that active managers have an advantage in bear markets.

Unfortunately, during bear markets, active managers do not necessarily outperform. That's a conversation for another time.

Tim Farley - Farley's Investment Strategy:

Again, it's difficult, and there are other things like when you start thinking about the composition of benchmarks, multi-sector benchmarks that typically people use as their fixed interest benchmark.

The Bloomberg all maturities index has got a duration of 5 or 6. Certainly most of my clients for the last 10 years have been really heavily weighted into bank hybrids and they have slaughtered that benchmark. You know, they have beaten that benchmark, over the last 12 years, I think bank hybrids are up in aggregate 80% government bonds are up 20%.

It's a massive out-performance, but when you looked at a fund that was managing those bank hybrids for example, typically they under-performed by about half percent a year So how do you take that into account? That is another really interesting question.

Emily Barlow - Perpetual Private:

And then there's a question on that being the right benchmark, right? Like there's all sorts of different risks associated with hybrids that don't exist in government bonds. So, is it the right benchmark to be benchmarking like hybrids?

Tim Farley - Farley's Investment Strategy:

Yes.

Emily Barlow - Perpetual Private:

And that comes down to other asset classes, which gets me back to the question that I was going to ask around alternatives, which is a very broad asset class, being increasingly allocated to and from an investible benchmark perspective, options are really limited.

So often we are looking at cash plus benchmarks, which aren't investible.

So, then you end up with a composite benchmark which actually is not achievable from a passive perspective. How do you both think about that issue, and have you thought through how we should be resolving that?

Julie Ballard - S&P Dow Jones Indices:

That is a good question, Emily. As the allocations to alternative assets in managed accounts are definitely increasing.

In terms of resolving or finding a solution to how alternatives should be benchmarked within managed accounts, I think that should really be done through industry consultation and IMAP is in a position to drive that. There are a couple points I can make around the issue of benchmarking alternatives (alts).

So first, we often come across the assumption that there are no appropriate benchmarks for alternatives and that is not necessarily true across the broad universe of what is considered to be alts at S&P DJI, we calculate around a million indices globally, and the selection of indices continue to expand as data becomes available and technology makes it more feasible to analyze comprehensive data sets.

Second, there are some benchmark options available for alts. Currently these include public market equivalent or PME benchmarks.

Julie Ballard - S&P Dow Jones Indices:

An example of a PME would be to compare a healthcare PE fund to an index of publicly traded healthcare stocks. Another example would be for an alternative investment in infrastructure that may be able to use an infrastructure index based on publicly available information.

As I've mentioned, these indices or these types of indices are being calculated and are available. Now there's also the option to create custom benchmarks and customisation can be as simple as tailoring an existing index, such as taking a broad infrastructure index and focusing on a specific region or a relevant infrastructure cluster such as energy, transportation or utilities to make it more appropriate for your use for private equity, venture capital, real estate and private credit.

At S&P DJI, we collaborate with Cambridge Associates to provide benchmarks in the space already. And lastly, if you are unable to find a suitable benchmark, I think it's worth noting the CFA GIT standard does have a section on this.

Julie Ballard - S&P Dow Jones Indices:

I know I refer to the CFA standards quite a bit.

That's because they do have best practice guidelines already, and a good number of our audience members are CFAs. So, in the GI standard there is a section titled 'No appropriate benchmark" with suggestions on what to do, but before deciding, there is no appropriate benchmark for your situation. I do suggest speaking to an index provider like ourselves, and also having a look at the S&P Dow Jones Indices website. We do provide a lot of detail on what is available, and we also have the ability to download up to 10 years of index level data freely for limited use. You may be very surprised with what you will find.

Tim Farley - Farley's Investment Strategy:

The alternatives question's a really good one. And I mean, Julie outlined really well just how hard it is at an individual asset class level to get something that's in any way meaningful.

And you know, even down to the types of work you'll do with Cambridge, essentially, you're talking about peer benchmarks again, which elsewhere in the CFA paper, say are useless. Well, they're the only thing you have there. So they are the best one. They may not be perfect, but they're the best one you've got.

Emily Barlow - Perpetual Private:

And what you risk with some of these industry or peer benchmarks, is that those that are selected to be included are the better performers. So, in and of itself, there are challenges with those benchmarks.

Tim Farley - Farley's Investment Strategy:

Absolutely. And the whole survivorship bias thing is a massive issue. Having said that, for someone running a multi-sector portfolio, there's actually a really simple solution to this, and it's certainly something my clients do where we basically say our neutral portfolio (call it our benchmark portfolio), doesn't have any of this stuff in there.

We are able to invest in it, but only when it's better, or we believe we have achieved better outcomes than the listed alternative.

Then we just compare it to what would've happened if we'd been in the listed, and your whole rationale for putting this in the portfolio is we are going to use private equity, because we're going to get better outcomes than we would get with listed equity, for example.

Emily Barlow - Perpetual Private:

But what time horizon do you look at that for Tim?

Tim Farley - Farley's Investment Strategy:

Well then you need to have an appropriate time horizon. I would say anything less than 7 years is pretty much meaningless. As for the risk adjusted benchmarks where you are looking at volatility and things like that.

Just throw them out the window, because as soon as you introduce an unlisted asset; any listed versus unlisted volatility measures are totally meaningless or at worst they're misleading.

Everything's wrong with them. So, you best have a look at saying, "what are my outcomes over this time horizon", and "over a 6 or 7 year period, do I get better than putting the money into direct equities or not?" That's really where your benchmark will come in. So, it does take a long time, but you know, with most of these portfolios (depending on the nature of the strategy), you ought to be looking at 6 or 7 years.

Tim Farley - Farley's Investment Strategy:

Now if someone's got a trading strategy where they basically say, we've got a neutral allocation and we take lots of small bets, that typically last anywhere between a month and three months, well yes give it a 2-to-3-year time horizon.

And because hopefully over that period, the skills will be starting to show through. If you've got a whole lot of things like private credit, private equity, direct property, direct infrastructure, well, you really need 7 years to see the full cycle if you have actually made a good decision or a bad decision.

Emily Barlow - Perpetual Private:

Yes, that's a really good point. We are already coming up towards the end of our time, so I just want to finish off by asking you both what key messages you would leave with our audience today when it comes to benchmarking. And Julie, would you like to go first?

Julie Ballard - S&P Dow Jones Indices:

Thanks Emily. I would like to close by pointing out the increasing scrutiny of performance. Last year, APLIS performance test was extended to include trustee directed choice funds.

And earlier this year ASIC released report 779, which looked at the conduct of superannuation trustees, advisors and licensees highlighting that there is often insufficient focus on performance. Whilst there is uncertainty as to exactly how this will extend to managed accounts, I think what is clear is that performance is becoming even more of a focus.

Whether a portfolio is outperforming or underperforming is all relative to the benchmark. So, it's vitally important, that we have a good understanding of the different types of benchmarks available and question whether the benchmark being used is the most appropriate for that portfolio.

Emily Barlow - Perpetual Private:

Great, thanks Julie. And you Tim?

Tim Farley - Farley's Investment Strategy:

I would say that anyone who is considering using a benchmark either for evaluating someone else's or their own performance, just get absolute clarity exactly why you're doing it, and that will shape what benchmark you take and how you look at things.

And really try and understand what's in this benchmark and does it act, is it a "like for like" comparison? And so, there's quite a lot to it, but the first step.... and the most important step, is to be really clear in your own mind what you're trying to achieve here. And that will help a lot.

Emily Barlow - Perpetual Private:

Well thank you so much Julie and Tim, and to our audience for listening to today's podcast episode.

I hope this discussion has shed some light on some of the nuances of benchmarking for managed accounts, and how we might start to improve benchmarks to enable better performance monitoring.

Selecting the right benchmark is critical for measuring performance, but it's equally important to be able to communicate clearly with clients about why that benchmark was chosen and how it aligns with their long-term goals.

Thank you again to our guests, Julie and Tim, for sharing their insights.

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