Timely Topics

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The Benchmark Standard

Highlights

LPL Financial Research believes investors need to choose a benchmark that best reflects the investment style of their accounts.

Simplicity is key. A benchmark should be easily understood and applied consistently in order to facilitate a robust and meaningful performance comparison.

At LPL Financial Research, we are constantly measuring the performance of our portfolios relative to the appropriate benchmarks.

Investors often face a challenging question when trying to assess the performance of their portfolios: what is the appropriate benchmark for relative comparisons? Given the plethora of benchmark choices available in today's market with various degrees of complexity, ranging from broad market indexes to niche alternative strategies, the decision is not always a simple one. A number of factors, both qualitative and quantitative, can play into the decision-making process. LPL Financial Research believes that investors need to choose a benchmark that best reflects the investment style of their accounts and one that is easily understood and applied consistently in order to facilitate a robust and meaningful performance comparison.

What Is a Benchmark, and Why Is It Important?

Merriam-Webster defines the term "benchmark" a number of ways, most notably as it relates to investments as "a point of reference from which measurements may be made" or "something that serves as a standard by which others may be measured or judged." While many investors are not concerned with portfolio performance compared to a benchmark, or relative performance, and are instead more focused on absolute returns (e.g. a 5% annual return), the concept of returns relative to a benchmark is ingrained in the investment industry. "Benchmarks and indices play a key role in financial markets," according to a brief from the CFA Institute[1] (*Benchmarks and Indices*, April 2013). They function as portfolios for investors seeking passive exposure to a particular market segment, serve as performance standards against which to measure the value generated by active managers, act as proxies for asset classes, and provide a reference point for determining the price or value of various financial instruments or transactions." In the daily work done by the LPL Financial Research Manager Strategy team, for example, we are constantly assessing the performance of investment managers to try and identify managers that demonstrate the ability to consistently outperform a benchmark over longer periods of time.

So if a benchmark is intended to serve as a standard for comparison, how does an investor choose the right benchmark? LPL Financial Research believes that the most appropriate benchmark for your portfolio is the one that most accurately reflects your investment profile.

A benchmark does not have to be complicated in order for it to be useful in assessing relative performance of a portfolio. In fact, the more increasingly complex the benchmark, the more difficult a comparison could be potentially.

LPL Financial long ago created benchmarks based upon five investment objectives with varying risk profiles (Aggressive Growth, Growth, Growth with Income, Income with Moderate Growth, and Income with Capital Preservation). The investment objective benchmarks are what we refer to as "blended benchmarks," in that they combine to varying degrees, depending on the investment objective, an allocation to a broad equity index, a broad fixed income index, and cash. These three asset classes are represented by the Russell 3000 Index, the Barclays Capital U.S. Aggregate Bond Index, and the Citigroup 3-month Treasury Bill Index, respectively, as noted below [Figure 1]. In our opinion, a benchmark does not have to be complicated in order for it to be useful in assessing relative performance of a portfolio. In fact, the more increasingly complex the benchmark, the more difficult a comparison could be potentially.

1 LPL Financial Investment Objective Blended Benchmarks

Investment Objective	Russell 3000 Index	Barclays US Aggregate Index	Citigroup 3-month Treasury Index
Aggressive Growth	95%	0%	5%
Growth	80%	15%	5%
Growth with Income	60%	35%	5%
Income with Moderate Growth	40%	53%	7%
Income with Capital Preservation	20%	70%	10%

Source: LPL Financial 06/30/14

All indices are unmanaged and cannot be invested into directly.

Please refer to page 7 for investment objectives.

LPL Blended Benchmark Index Definitions

Russell 3000 Index: The Russell 3000 Index measures the performance of the largest 3000 U.S. companies representing approximately 98% of the investable U.S. equity market. The Russell 3000 Index is constructed to provide a comprehensive, unbiased, and stable barometer of the broad market and is completely reconstituted annually to ensure new and growing equities are reflected.

Barclays US Aggregate Bond Index: The U.S. Aggregate Bond Index is a broad-based benchmark that measures the investment grade, U.S. dollar-denominated, fixed-rate taxable bond market, including Treasuries, government-related and corporate securities, mortgage-backed securities (agency fixed-rate and hybrid ARM pass-throughs), asset-backed securities, and commercial mortgage-backed securities.

Citigroup 3-Month Treasury Bill Index: An unmanaged index representative of three-month Treasury bills.

The investment objective benchmarks are an integral part of being a client of LPL Financial, from the moment you open an account through the ongoing performance review you have with your advisor. This dynamic process centers around selecting the appropriate investment objective profile from the time the account is opened based on your investment preference, time horizon, risk tolerance, income needs, tax preferences, and other special situations. Identifying each of these areas of need up front and selecting the appropriate investment objective is paramount, as is then using the appropriate benchmark for comparison going forward—since it would not be appropriate to compare your performance against a benchmark that does not match your investment objective. Additionally, the same benchmark should be used for ongoing comparison. Frequent switching of a benchmark makes it difficult to assess relative performance over the life of your portfolio. Therefore, keeping the blended benchmark broad in its scope allows for it to remain intact over the life of your portfolio.

As an example, let us assume that a Growth with Income investment objective was most appropriate as determined by you and your advisor. Thus, your preferences likely included some combination of a need to

Keeping the blended benchmark broad in its scope allows for it to remain intact over the life of your portfolio.

balance growth and income with a moderate tolerance for risk and an intermediate investment time horizon. In this situation, LPL Financial has determined that the most appropriate benchmark to compare your performance against is a balance of stocks (60%), bonds (35%), and cash (5%) as highlighted in the Growth with Income benchmark in Figure 1. It is possible, if not entirely probable, that the construction of your portfolio will differ at times and fluctuate from the composition of the benchmark based on decisions made by you and your advisor; your portfolio will not always look like the benchmark. How you achieve your financial goals is a personal decision, best made in consultation with your financial advisor. However, what that overall performance experience should generally feel like over time is best reflected in the LPL Financial investment objective benchmark.

The blended benchmark will provide an idea of the path that you may take to reach your goals, but the exact route you ultimately take will be influenced by the decisions you and your advisor make to address your specific needs.

To use an analogy, the blended benchmark will provide an idea of the path that you may take to reach your goals, but the exact route you ultimately take will be influenced by the decisions you and your advisor make to address your specific needs. Therefore, your portfolio deviation is largely to be expected, yet the investment objective blended benchmark provides a steady framework for comparison regardless of the underlying composition of your account. Over time, your goals and financial situation may also change. It is important for you to discuss any changes with your advisor, as your original investment objective may need to be re-evaluated and, thus, the appropriate benchmark for comparison.

Keep it Simple

As previously mentioned, LPL Financial Research believes that one of the most important characteristics of a benchmark is simplicity. Not simplicity in the composition of the benchmark or underlying index per se, but simplicity in the approach. All three of the indexes used to construct the LPL Financial investment objective benchmarks are complex in their methodologies and constitution, but are easy to understand as a proxy for the broad asset class each represents.

For example, according to Russell Investments[2], the Russell 3000 Index represents 98% of the investable U.S. equity market with stock market capitalizations of companies in the Index ranging from the smallest member at $169 million to the largest constituent at $545 billion (as of May 31, 2014). The Index is reconstituted on an annual basis each May to ensure the Index is representative of the broad U.S. equity market. While the construction and reconstitution process undertaken by each index goes beyond the scope of this paper, it is certainly worth visiting the sponsor websites directly for investors that would like more information.

The LPL Financial investment objective blended benchmarks were also constructed with simplicity in mind.

The LPL Financial investment objective blended benchmarks were also constructed with simplicity in mind. The intention of the benchmark is to provide you with a broad representation of the major asset classes (stocks/bonds/cash) as a standard of comparison for your portfolio. This is done, in part, to demonstrate the value-add that a diversified asset allocation could potentially bring to your portfolio. At a high level, one of the easiest ways to view the asset allocation decision is to view cash as a percentage of the

Asset allocation decisions should be readily apparent to you when viewing your portfolio relative to the benchmark so that you can easily facilitate a meaningful portfolio comparison.

overall portfolio. If we use the Aggressive Growth investment objective blended benchmark (95% stocks/5% cash) as an example, all else being equal, your portfolio should benefit from an asset allocation perspective for having a lower cash balance relative to the benchmark in a rising stock market and a higher cash balance in a declining stock market.

The introduction of sub-asset classes to the LPL Financial blended benchmark beyond the basic stocks/bonds/cash asset class framework, however, makes it increasingly more difficult to discern the value of asset allocation decisions in your portfolio. In Figure 2 we show a hypothetical Growth with Income portfolio allocation containing 11 sub-asset classes. It would be incredibly difficult to determine the contribution from asset allocation if the investment objective blended benchmark consisted of 11 sub-asset classes, instead of three high-level asset classes, not to mention the difficulty associated with how to construct that benchmark in a consistent and repeatable fashion to ensure it remains viable as a standard for comparison.

Asset allocation deviations from the benchmark represent the belief of the investment manager (you and your advisor in the case of your portfolio) as to the potential direction of the markets. These asset allocation decisions should be readily apparent to you when viewing your portfolio relative to the benchmark so that you can easily facilitate a meaningful portfolio comparison.

2 Hypothetical Growth with Income Portfolio

	Fund Name	Sub-Asset Class	Allocation (%)
Equity	Fund A	Large Growth	13
	Fund B	Large Value	13
	Fund C	Mid Growth	7
	Fund D	Mid Value	7
	Fund E	Small Growth	5
	Fund F	Small Value	5
	Fund G	Large Foreign	6
	Fund H	Emerging Markets	4
Fixed Income	Fund I	Intermediate-/Long-Term Bond	25
	Fund J	High-Yield Bond	10
	Cash*	Cash	5
	TOTAL		100

Source: LPL Financial 06/30/14

* The cash portion of this portfolio is represented by money market instruments.

Please note: The portfolio listed above is for illustrative purposes.

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Our Standard

At LPL Financial Research, we are constantly measuring the performance of our portfolios relative to the LPL Financial investment objective benchmarks. We believe the benchmarks are robust in both their construction and underlying constituents and easy to comprehend on both a standalone basis and as a beacon for measuring relative performance. The benchmarks provide a suitable comparison for clients that are trying to assess the performance of their portfolio, gain a further understanding of how it compares to broad markets, understand the investment decisions being made by their investment manager, and most importantly, perhaps, provide a basis for making changes to the portfolio as market conditions warrant. ■

REFERENCES

[1] Formerly known as the Association for Investment Management and Research (AIMR), the CFA Institute is an international organization comprised of more than 70,000 members who hold the Chartered Financial Analyst (CFA) designation or are otherwise bound by its rules. Its primary mandate is to specify and maintain a high standard for the investment industry.

[2] Founded in 1936, Russell Investments is the creator of the Russell Global Indexes, including the Russell 3000 Index, that have $3.9 trillion in assets benchmarked to them.

IMPORTANT DISCLOSURES

INVESTMENT OBJECTIVES

Aggressive Growth

Aggressive Growth will essentially be fully invested in equity assets at all times (with the exception of a 5% cash position). Investors in this portfolio should have a long time horizon of 10 years or more, an understanding of the volatile history of equity investments, and a propensity to add money to the account on a systematic basis.

This portfolio is very aggressive by nature and should not be considered by anyone unwilling to take on significant risk.

Growth

Growth will be targeted to an allocation of 80% in equity assets and 20% in fixed income assets (including a 5% cash position). Investors in this portfolio should have a long time horizon, an understanding of the volatile history of equity investments, and a propensity to add money to the account on a systematic basis. This portfolio is aggressive by nature and should not be considered by anyone unwilling to take on significant risk.

Growth with Income

Investors in this portfolio should have a long time horizon, and an understanding of the volatile history of equity investments. The primary investment objective of this portfolio is growth of principal. Fixed income assets are included to generate income and reduce overall volatility.

Income with Moderate Growth

Income With Moderate Growth will be targeted to a normal allocation of 40% in equity assets and 60% in fixed income assets (including a 7% cash position). Investors in this portfolio should have a time horizon of more than five years, and be comfortable with the volatile history of equity investments. The primary investment objective of this portfolio is income, with growth of principal an important consideration. Fixed income assets form the core of the portfolio, generating income and lowering the portfolio's overall volatility. Equity assets provide the opportunity for long-term growth of principal.

Income with Capital Preservation

Income With Capital Preservation will be targeted to a normal allocation of 20% in equity assets and 80% in fixed income assets (including a 10% cash position). Investors in this portfolio should have a time horizon of more than five years, and be comfortable with the volatility that will occur within the modest equity portion of their investment portfolio. The primary investment objective of this portfolio is income, with growth of principal as a secondary concern. Fixed income assets form the core of the portfolio, generating a steady income stream. A small investment in equity assets provides the opportunity for modest long-term growth of principal.

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