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Multi-Asset Portfolios, Benchmarks and Client Goals

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Benchmarks are standards used to measure quality in many areas, front and center among them investment management, where they play a prominent role.

It's common to think of benchmarks as market indexes against which portfolio managers compare investment returns, but we should remember that they're used by investors as well. These two groups have different aims, and we need a broader view of benchmarks to enable us to assess what constitutes success for each group. For fund managers, it may be generating a higher return than a benchmark index. Investors, on the other hand, succeed when returns on their investment portfolios help them meet their financial goals.

We help investors pursue their financial goals by managing investment portfolios, which typically consist of multiple asset classes and a mix of managers. Our focus is to build a multi-asset class portfolio management process with benchmarks chosen to be aligned with the need for investors to first define their goals clearly, set reasonable expectations for portfolio returns given the investment horizon and ultimately attempt to maximize the likelihood of success in meeting goals.

Our objective here is to explain how benchmarks are used in the construction of portfolios to align them with investors' stated financial goals. We will explain benefits of benchmarks, how we incorporate them into portfolio construction and why we believe it matters. A typical measure of success used by investors is being able to meet their goals. For example, a pension plan that has present and future liabilities to meet, needs to have enough assets that generate adequate cash flows for that purpose. Such an investor relies on industry-wide benchmarks such as the Citigroup Pension Liability Index (CPLI) to help quantify its liabilities through the appropriate discount rates, and in turn determine its funding status, and therefore the likelihood of succeeding in meeting its liabilities.

Perspectives vary

When describing benchmarks, it's important to consider the various perspectives held by the parties using them:

Fund Managers view benchmarks as reference points for how well they perform when managing portfolios, and as a way of signaling to investors their investable universe. Indeed, benchmarks may form the basis of any incentive compensation they receive. To that end, they tend to select as benchmarks indexes that represent their investable universe as closely as possible. For example, the S&P 500, the MSCI ACWI, the Bloomberg Barclays Global Aggregate, or appropriate combinations of them may be appropriate for managers of multi-asset class portfolios. Selecting the S&P 500 would inform investors that they're a U.S. large cap manager, the Russell 1000 Growth a large cap manager with a growth bias and the ICE BofA Merrill Lynch U.S. Corporate Index a manager of U.S. investment grade corporate bonds.

For investors, performance relative to a benchmark index could be misleading, since it takes the focus away from how investment performance can help them meet their goals, such as maintaining spending policies; preserving or growing a portfolio; keeping up with, or outpacing inflation, or meeting specific needs of the investment portfolio's beneficiaries. Some investors may even have as one of their goals to match the performance of a major market index, or even to outperform it, and they use that index as their official or unofficial portfolio benchmark. A common index some investors want to match or exceed is the S&P500; if they don't, many think of it as a failure. It is also common for clients to use index benchmarks to assess whether they receive good value for the fees they pay managers. Some evaluate their portfolio's performance against our multi-asset class benchmark.

Exhibit 1: Motivations of fund managers and investors with regard to benchmarks

Fund Managers	Investors
Use benchmarks as reference points for how well they perform when managing portfolios – A vital aspect of how they are incentivized if their compensation includes performance fees	Should view benchmarks as measures of success in the context of meeting or exceeding their goals – May have as a goal to earn the performance of a major market index or even to outperform it
Tend to select benchmarks representing their investable universe as well as possible, including combinations of indexes for multi-asset portfolios	It is common to use index benchmarks to assess whether they receive good value for the fees they pay managers.
Use benchmarks to signal to potential investors their universe of investable assets	Some tend to evaluate their portfolio's performance against a multi-asset class benchmark

Sources: GWIM CIO Portfolio Construction and Management, GWIM CIO Due Diligence, U.S. Trust Institutional Investment Management Group

As for risk, investors usually relate it to the likelihood of not meeting their financial goals, while fund managers typically associate it with underperforming a benchmark index or otherwise generating undesirable returns.

Reconciling the differences

Given the potential diversity of motivations between managers and investors, we seek to reconcile the differing utilizations of benchmarks. For example, a fund manager may be unhappy about producing a return net of fees that modestly trailed a portfolio's benchmark, but some investors who own the portfolio may be happy with that return in risk-adjusted terms if it has helped them meet most or all of their goals.

In addition, issues may arise when fund managers or investors view benchmarking only through the lens of return without regard to the level of risk appropriate for the investors' financial goals. For example, an investor who only needs a modest return over a short or intermediate time horizon to achieve major goals perhaps should not be exposed to the volatility of an equity index such as the S&P 500. Even if that means a lesser expected return, it is a decision worth considering since it reduces the likelihood of a significant shortfall with regard to financial goals.

Evaluating an individual manager or the level of satisfaction relative to the investor's goal may result in conflict. One could say that we use a benchmark to see how "well" a manager performed, but we need to define "well" relative to their goal or objective, so each case may be different.

Addressing the investor's view

To better manage expectations, it is critical to understand the implications of measuring product performance versus asset class performance. An investor may have performance expectations from observing an index, but the reality is that the performance of an asset class within a portfolio rarely if ever exactly matches that of the index. This is true for both active and passive strategies. Active strategies have tracking error consciously and intentionally introduced by the manager gaining exposures different from those of an index in an effort to outperform it. Passive strategies still have tracking error with respect to their underlying index, though typically unintended and a lot smaller than for a corresponding active strategy. As a separate point, historically, investors seldom realize the potential performance of products due to the tendency to buy near the highs and sell near the lows; products with the appropriate amount of volatility to allow for long-term investment thus can help them realize the full return of that investment.

Aligning clients' investment strategies with their mission and goals

It is now clear that to improve outcomes we should aim to reconcile the differing points of view and objectives of an investor and the managers in the investor's portfolio. This was not always a recognized need. For a long time, many investors focused on investment returns from their portfolio and did not pay much attention to the risk needed to achieve those returns, as well as how adverse risk outcomes could affect the likelihood of achieving their mission and goals.

Another point to emphasize is that an investor's failure to meet goals isn't necessarily the result of poor investment performance by one or more managers in the client's portfolio, or market volatility, selloffs or crashes. It can also be the result of the investor's behavior after observing low or negative returns in their portfolio. While we want to educate our clients to focus on long-term goals and investment outcomes, it takes enormous discipline for them to act as long-term investors. Human psychology is such that at times of adverse outcomes investors are very quick to switch their focus from long-term to short-term, sell out at the worst time and never have the chance to recoup any short-term losses because they lost their market exposure and missed the market rebound. Such behavior can cause clients to miss their goals and fail to fulfill their mission.

Since the switch of focus from long-term to short-term often takes place when the investor's experience deviates from expectations, our approach to building multi-asset portfolios, as outlined above, aims to align the portfolio returns with clients' goals by choosing investments designed to stay within the realm of expectations. Our systematic step-by-step approach to portfolio construction helps address this.

Our multi-asset portfolio management process

Our multi-asset class portfolio process is designed to help clients meet their goals, objectives and needs, or fulfil their mission, while aiming to meet and potentially exceed their expectations. It consists of the following steps:

1. **Building a client's profile:** We invest significant effort in gaining a comprehensive and thorough understanding of the client's mission to craft an investment strategy that aligns with their financial goals.
2. **Creating a customized asset allocation and an investment policy statement specific to each client:** Overall objectives, including needs, wants and aspirations, as well as the risk tolerance, desired cash flows, potential restrictions and tax situation are unique to each client and therefore call for a customized approach.
3. **Constructing a portfolio and implementing an investment plan:** We follow a rigorous, proprietary approach to help accomplish these objectives.
4. **Align asset allocation to the overall wealth plan:** We achieve this alignment through a dynamic process as the client's needs evolve.
5. **Monitor and manage the client's portfolio:** Performing these duties involves ongoing due diligence, oversight and periodic rebalancing, as appropriate.

Our **CIO Portfolio Construction and Management Process** consists of three pillars:

1. We assess investments both quantitatively and qualitatively. Through our **Quantitative Screen**, we evaluate historical risk and return characteristics, and analyze performance in different market environments. Our **Qualitative Review** entails thorough assessment of the organization and investment strategy of managers, which includes evaluation of their investment team and process, size and liquidity and portfolio exposures.
2. In each portfolio, we identify combinations of investments that can potentially outperform benchmarks but also provide diversification. Our **Investment Selection and Sizing** helps ensure that portfolios align with investors' philosophies, while helping them pursue their goals, objectives and needs. We manage Hybrid portfolios, whereby we mix active and passive strategies; **Hybrid & Active** portfolios, in which we select investments and portfolio weights based on potential return, tracking error, and costs, and **Passive** portfolios, in which investments can track corresponding indexes at a low cost.
3. We monitor performance and risk on an ongoing basis.

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Asset allocation and diversification do not ensure a profit or protect against loss in declining markets.

Risk management, diversification and due diligence processes seek to mitigate, but cannot eliminate risk, nor do they imply low risk.

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Any investment plan should be subject to periodic review for changes in your individual circumstances, including changes in market conditions and your financial ability to continue purchases.

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