Bailard Research

Portfolio Management, Indices, Benchmarks and Competitor Benchmarking

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ABSTRACT

From sports to the corporate world, what does it take to be successful? Skill, dedication, practice, focus—these qualities spring to mind. But to win it is also essential to know at what standard you must compete and against whom. In the sport of running, a miler who can break four minutes is good, but a miler who wins races against the best of his peers is the one who collects the medals. Similarly, in the asset management business, a mutual fund manager that outperforms a market index may be good, but a mutual fund that outperforms its peers is the best in its class!

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MUTUAL FUNDS IN THE 21ST CENTURY

The mutual fund world has been institutionalized. Today there are more that 8,000 mutual funds according to ICI, the industry's trade group. Expert firms like Lipper, which formed in 1973 when there were only 421 mutual funds, and Morningstar, which began in 1984, another 822 funds later, have grown up and made names for themselves by placing mutual funds into categories based on style and relative performance, for example, through the award of stars or the publication of a ranking within a peer group. The stars connote consistent achievement. Amongst active managers, success is defined by maximizing stars and staying in the highest ranks. What is the role, if any, of traditional benchmarks based on market indices in this arena?

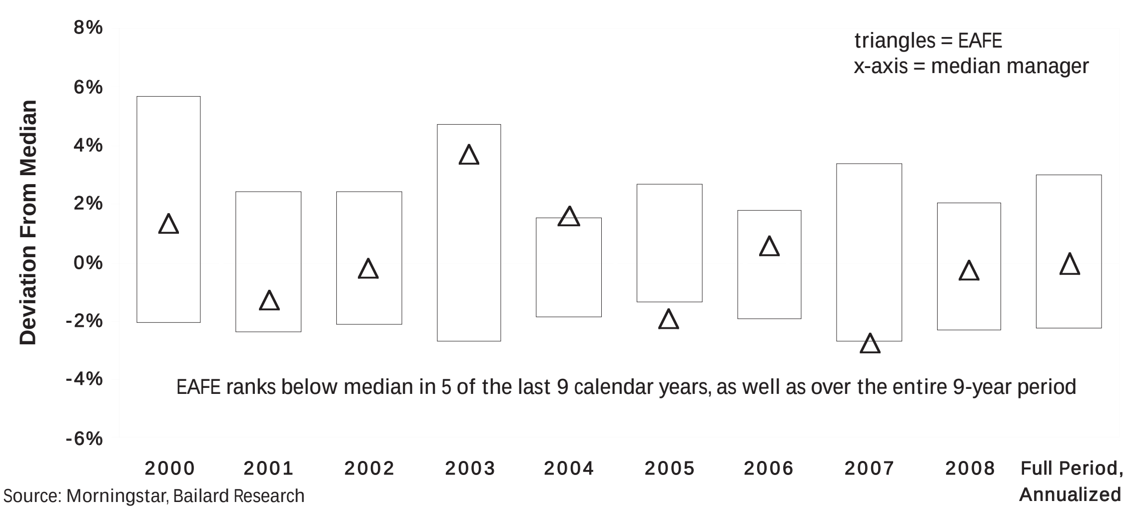
AN INDEX VERSUS AN AVERAGE

An index represents a passive alternative to active fund management. Philosophically it is the opposite of active management and, as such, it is a good measuring rod for the active versus passive approach. But for the active mutual fund manager, we believe the real goal is "winning the league." Traditional index benchmarks may be useful for this goal (as an opponent to play against) only if they are a proxy for the average competitor. Unfortunately, benchmarks based on indices are very often unreliable guides to the average performance of mutual fund portfolio managers. The reason is simple: in many categories of mutual funds, active managers do not invest in a manner that is similar or tightly constrained to their named index. As a result, over some time periods, the index performs better than the category average, and over other periods performs worse. In these circumstances, a manager who wants to win consistently would be unwise to focus his portfolio bets relative to an index, since the index does not represent the players against which he is competing. In modern portfolio jargon, a manager may have great alpha, but, if the alpha is attached to the wrong benchmark, he might still find himself in the bottom half of the league table!

A CASE STUDY: THE MORNINGSTAR FOREIGN LARGE BLEND CATEGORY

By way of example, consider the Morningstar Foreign Large Blend category. Exhibit I below shows how the well-known international equity index, MSCI-EAFE, Morgan Stanley's Europe Australia & Far East index (EAFE), performed versus managers in the Morningstar Foreign Large Blend category. EAFE expresses returns in dollars and includes net dividends. To make comparisons fair we have also deducted 1% from the annual index return as a proxy for annual total expenses of foreign large blend mutual funds. The bars represent the 25th percentile (at the top) to the 75th percentile range

EXHIBIT I: MSCI EAFE VS.INTERNATIONAL EQUITY MANAGERS
(REPRESENTED BY THE INTERQUARTILE RANGE OF THE MORNINGSTAR FOREIGN LARGE BLEND CATEGORY)



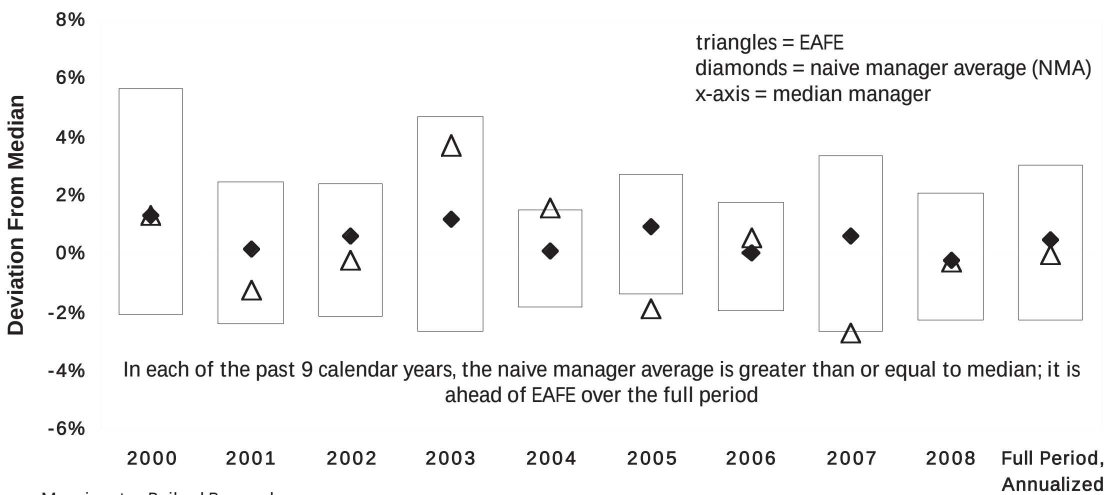
Source: Morningstar, Bailard Research

of results for all funds in the category for each year. The horizontal axis represents the performance of the median manager for each year. All fund returns are in U.S. dollars and are net of the funds' total expenses. It is readily apparent from Exhibit I that EAFE is not a good indicator of the median return in any year and would have ranked below median in five out of nine years. Therefore even consistently beating EAFE by 1% each year (a solid "alpha" by institutional standards over nine years) would have resulted in below median performance one third of the time. 2007 would have been a particularly frustrating year, since beating the EAFE benchmark by 1% would barely support squeezing into the third quartile. Over the full nine-year period, EAFE is a better measure of median performance, but in this case still would have underperformed the median manager (last bar on the right of the chart).

take the average or mean return (unweighted) of all managers in the category each month and multiply these returns over each month to arrive at a return for the year. Note that we choose to use the mean return, not the median return. This is important. Through observation of the graph below, we can see that the median manager return is not a good measure of the midpoint of all manager performance. The distribution of manager returns is usually not "normal," but skewed towards the upside. As a result, more often than not, the mean return is above the median and likely to prove a better performing benchmark than the median.

In exhibit II, we show the results for this benchmark (NMA) versus the median manager (horizontal axis) and EAFE. Note importantly, over the nine years from 2000 to 2008, the NMA is greater than or equal to the median manager. In three of nine years it underperforms EAFE, in four of nine years it outperforms and in two years ties with EAFE. It is a superior benchmark

EXHIBIT II: NAIVE MANAGER AVERAGE VS. MSCI EAFE



Source: Morningstar, Bailard Research

IN SEARCH OF A SOLUTION

Is there a better way for a manager to improve the probability that consistent outperformance (alpha) will result in stars and high rankings? We believe there is.

To increase the probability that skill will result in stars and high rankings, a portfolio manager must "play against" the average manager, not an index.

Step 1 then is to create an index of competitors by asking: how has the average manager performed each month? We will refer to this as the "naïve manager average," or NMA. The NMA simply assumes that we

over this period not only to EAFE, but over the full nine years it also outperforms the median manager.

We can see then that the mean manager performance (the NMA) is a good benchmark. In this example, beating this benchmark means always being in the top half of competitors. But how do we capture this naïve benchmark in the real world—a world where we do not have contemporaneous information about our competitors? While we do not have current information, we do have relatively recent detailed (and public) information about competitor portfolios available (it is usually from six to fifteen weeks old). With this data we can make an estimate of the overall average portfolio each month. In the international area, where there are thousands of global stocks, the information can be used to estimate an average competitor portfolio based on criteria such as country weights. Alternatively, the data can be used to estimate average competitor sector weights or even average stock holding weights. Modern data-handling and processing techniques, combined with ever-wider public disclosure of positions, make this all possible.

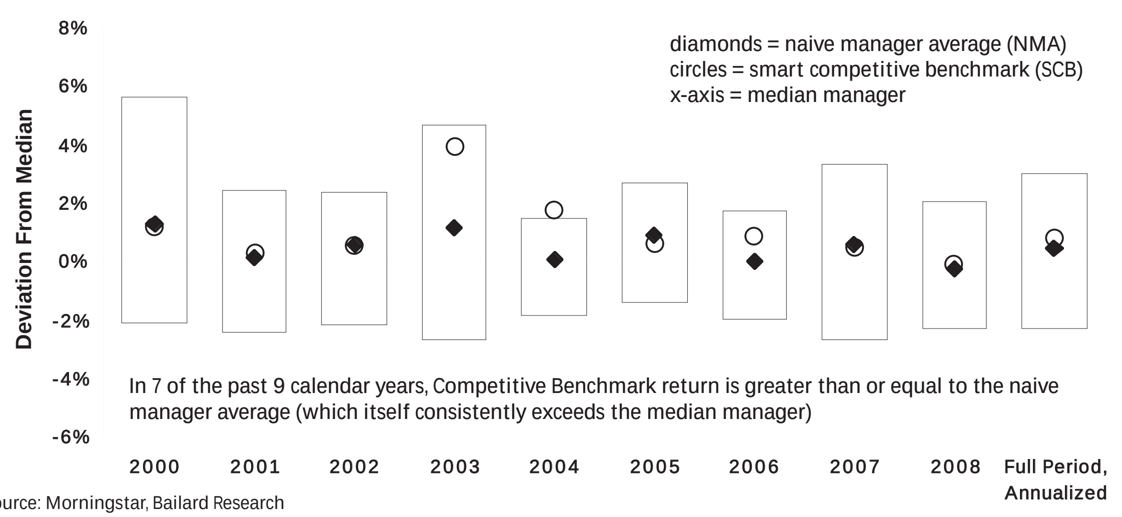
By way of example, "average country weighting" is an important criteria for most international managers. Across all competitors in the Morningstar Foreign Large Blend mutual fund category, it is possible to extract enough data to assemble a hypothetical fund that represents an estimate of the average country weightings over all competitors. This can be done in a very simple fashion by extracting all the known country weightings for the funds at the beginning of each month. Then, at the end of each month, the start-of-month weightings are multiplied by the index returns for each country and the performance is rolled up over each month for the whole year.

This measurement of competitors could be criticized for using stale information, and for including funds pursuing eccentric strategies and funds with very high turnover. An alternative would be to develop a benchmark that we will call the "smart competitive benchmark" or SCB, which is based on reasonable process rules. For example, we could give newer data greater weight than older data, give lower turnover funds greater weight, exclude very new funds and exclude odd outliers (e.g. a fund that has 70% in Canada). If this information is systematically collected and updated regularly (say, at least monthly), is the SCB even more useful than the NMA?

Our practical experience in the foreign large blend category has shown us that the estimates drawn using methods similar to the SCB are good. We know this because, having assembled an estimate of the "average" portfolio (by country weights), we can use it to predict performance for, say, one month ahead. Then, we can compare actual average performance to predicted average performance. Our research suggests that the predicted average performance is surprisingly accurate and can provide a superior estimate of likely average manager performance than either EAFE or MS All-Country ex-US. All of this suggests that concern about the "staleness" of reported data is misplaced.

In exhibit III, we show a comparison of the SCB and NMA performance versus the actual median manager over the past eight years. The SCB

EXHIBIT III: SMART COMPETITIVE BENCHMARK VS. NAIVE AVERAGE



Source: Morningstar, Bailard Research

is the best benchmark, outperforming the NMA in nearly every year. Over the full nine years (last bar on the right) the SCB beats the median manager and the NMA.*

APPLICATIONS FOR USE

How do we use a smart competitive benchmark (SCB)? Does playing against the competitors increase risk? The SCB can be used just like a passive market index when it comes to decisions on overweighting,underweighting and risk control. Our experience suggests that there is nothing inherently riskier about the smart competitive benchmark either. If we look at the absolute annual volatility of the SCB, which we have calculated at 17% over the last nine years, it is in fact slightly less than MSCI All-Country ex-U.S. index, 17.5%, and EAFE, 16.7% (where returns of both indexes are expressed in dollars and include net dividends). This is exactly in line with what we would expect when we recall that EAFE has no emerging markets and the MSCI All-Country ex-U.S. usually has more emerging market exposure than the average manager. Importantly, using the smart competitive benchmark reduces the risk of suffering a severe underperformance of peers!

Keeping an eye on competitors is the norm in a society based on market competition, although most investment managers are reluctant to admit it. And, for the professional portfolio manager, it has additional benefits. It ensures that a manager will not be blind-sided by new companies, sectors and countries that creep into competitor portfolios. Decisions on whether to own or not still need to be made, alpha still has to be generated, but ignorance of the opportunity is no longer an excuse!

CONCLUDING THOUGHTS

Let's be clear: the number one goal for an active mutual fund manager is finding a way to consistently generate "alpha"; using a smart competitive benchmark does not change this fact. But it addresses fully the number two goal: "alpha" must be aligned with the strategic objectives of the fund. When the objective of the fund is to be amongst the best in its class of competitors, using a SCB just makes common sense because it can maximize the competitive advantage of a manager's alpha in a way that typical indices usually do not. It increases the odds that a good manager will win the medals, awards and five stars!

*Looking more closely into the question why the SCB outperforms the median manger is the subject of a separate Bailard Research white paper.

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