



FIM GROUP INVITES YOU TO

InvestNews – Question & Answer

Q: Performance, Indexes and Benchmarks?

A: FIM Group clients occasionally ask us how we “evaluate our performance” internally, and I thought it would be a good subject for this month’s forum.

Three things come into play when evaluating performance. First, the client’s needs. For example, if you’re retired, a portfolio that is managed and optimized to produce lifetime income security should be your overriding objective. It should trump lesser-priority goals such as wanting little or no (downside) volatility, predictable income, inflation protection/security, etc. Of course we all want it all, and I’ve yet to meet someone who minds upside volatility.

Second, client risk tolerance and constraints based on their personal biases, life experience, training and education. The best measure of a manager’s value is whether or not the client’s personal financial objectives are being met. If comparative analysis is desired, it is important that appropriate benchmarks are used. If an investor can only tolerate half of the historic downside volatility of the stock market, then comparing their performance to a stock index like the S&P 500 is not applicable. To appropriately benchmark whether a manager is adding value, one should compare how a client’s portfolio does on a risk-adjusted basis, over a complete market cycle, to a blend of indexes whose historic downside volatility matches the client’s risk tolerance.

Third, valuations, yields, inflation and forecasted expectations on returns. In 1981, our government issued a 20-year bond that paid 15.75% interest. Obviously a person who bought that bond would before taxes receive guaranteed 15.75% on their money if they held the bond to 2001. During that time the bond had years where it went up, down and sideways – but it paid an amazing \$15,750 annually for every \$100,000 face value of the bond. Today (1/11/11), U.S. government 20-year bonds pay 4.27% – less than one-third of those available in 1981. An investor would earn around \$4,270 for each \$100,000 face. In 1981, the world was a scary place – fraught with inflation, wars, unsteady economy and a silly political climate. Today, after the economic tsunami that hit a few years ago, people want gold and government bonds and are less keen on stocks. When stocks are expensive they have low expected returns (like the 4.27% government bond), and when they are cheap they have high expected returns (like the 15% government bond). So if a stock’s price-to-earnings ratio provides a great earnings yield, future returns can be forecasted over a long time frame – not a year or so because of the emotions and noise of the markets.

So when evaluating a portfolio’s performance, these three things must be considered. Where benchmarking and indexes come into play depends upon the managers doing the evaluating. Did the manager add value? In order to evaluate a portfolio manager’s ability to add risk-adjusted value, one should compare composites of all of a manager’s portfolios in each risk group, over complete market cycles, to appropriate indices. To determine how well a manager’s stock management skills are, his company’s stock or “growth” portfolio returns should be compared to an appropriate blend of equity indices. To determine a manager’s proficiency in managing balanced or “asset allocation” portfolios, the appropriate benchmarks would be blends of stock, bond and cash equivalent indexes.

At FIM Group we can and do internally review our performance to many indexes – but our most important consideration is, “Are we confident that our clients’ portfolios will perform as needed, so they can retire, stay retired, pay for their children’s education or continue to financially support their beneficiaries?” Of course, the yin and yang of this is when the stock market is up, we want stocks; when it is down, we want bonds; and when it is sideways, we want whatever went up.

Want to submit a topic or question for the next *InvestNews* or newsletter?

Contact Us

GLOBAL INVESTING AND CHRISTOPHER COLUMBUS

by Jeff Lokken, CFP®, ChFC®

In this newsletter, during our quarterly conference call, in individual client meetings and perhaps even in our sleep, the FIM Group adviser team is constantly discussing the concept of “global investing.” In addition to our continued emphasis on this important topic, the financial news also reports on many aspects of global investing, in particular ...

Read more about this article and the entire January newsletter at www.fimg.net

If you missed our last webinar, “2011...THE YEAR AHEAD” you can find it on our website at www.fimg.net.