The Problems with Trying to Benchmark Unconstrained Portfolios
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Benchmarking unconstrained, “go-anywhere” managers is difficult. Common methods to determine an appropriate benchmark – such as an ex-post regression of how the fund was invested – can obscure the actions of the manager. Is the only solution to simply select an arbitrary benchmark and proceed accordingly? Should we eschew a benchmark altogether?

I was interested to see a recent article highlighted in Advisor Perspectives, by Andrew Pyne of PIMCO, called, "Equity Investing: From Style Box to Global Unconstrained." I was hoping PIMCO might have new solutions to the problem of benchmarking unconstrained portfolios, but alas I found that Pyne was covering well-worn territory.

For Pyne, and for PIMCO, the question is, “should managers be style-constrained within the equity universe, or should they essentially be given the flexibility to wander outside of a particular Morningstar-defined style box within the equity universe?” In concluding that managers should be given such freedom, Pyne reviews a study of “active share” by Martijn Cremers and Antti Petajisto, both of Yale University, which found that during the past several decades portfolio managers have become less “active” and more like “closet indexers.” I devoted an entire chapter to this study in my 2009 book, "Buy and Hold is Dead (AGAIN), the Case for Active Management in Dangerous Markets." I concluded then, as now, that the study is only interesting in the context of comparing the performance of style-constrained money managers to a single index, and it has little to say about managers of portfolios that are completely unconstrained at the asset class level.

What Does It Mean To Be Unconstrained?

In PIMCO's definition of “unconstrained,” managers would be free to own LG (large growth), LV (large value), MG (mid growth), MV (mid value), SG (small growth), SV (small value), and even international equities in their pursuit of higher absolute returns. To be clear, though, PIMCO is not advocating that managers should be free to own any asset class, or particularly non-equity asset classes. Even PIMCO's "unconstrained" funds generally still must stay within their overall asset class; to do otherwise would create even more chaos than allowing so much freedom just within equities. For example, PIMCO publishes such restrictions for their Unconstrained Bond Fund. According to PIMCO, the
purpose of the constraints in this case is to make certain that the fund retains the characteristics of a bond fund, while giving the manager flexibility to own any kind of fixed-income security that might add to returns.

Clearly, PIMCO hasn’t decided to put itself out of business by creating a fund that doesn’t at least fit into a fixed-income style. After all, how would investors know what to do with such a fund? If it isn’t a fixed-income fund, then what is it, and how would you use it in the context of a diversified portfolio? Fortunately, the mere fact that the fund is still a “fixed-income fund” allows for some way to benchmark PIMCO managers to determine if they are earning positive alpha.

But when the portfolio is truly unconstrained and has no clear benchmark, how do you do the math? I know of what I speak when asking this question, because our portfolio construction at Pinnacle Advisory Group is not constrained at any level, including at the level of asset classes. Instead, we are constrained by volatility, not asset class targets, to allow our analysts freedom to select from any asset class that they believe offers good value (and to avoid any asset class that does not). A similar approach drew attention in the recent "Same Returns, Less Risk" Wall Street Journal article.

While such flexibility is very helpful for allowing our analysts to do what they do best, in the process we have created a relatively new kind of investment animal that makes life difficult for everyone who wants to analyze our investment returns, regardless of whether they are a retail investor or an investment professional. That was the challenge we set out to overcome.

**Choosing A Benchmark For Unconstrained Portfolios**

Pinnacle’s not-fully-satisfactory solution to the problem of needing to benchmark our five unconstrained portfolio strategies is to throw up our hands and choose the simplest two asset-class-blended benchmarks we can think of, which are comprised of varying exposures to the S&P 500 Index and the Barclay's Aggregate Bond Index. I

In a recent internal presentation, Carl Noble, CFA, Pinnacle’s international analyst, gave us some other examples of fund companies muddling through this unfamiliar territory. The choice of benchmarks seems arbitrary for them, too. Notably, when one relies on benchmarks constructed of traditional asset classes like stocks and bonds, the consequence is that any allocation to alternative investments like hedge funds, managed futures, and private equity – or other alternative asset classes with presumably low correlations to stocks and bonds, such as gold, real estate, and commodities – would constitute what we refer to as “benchmark risk.” Benchmark risk is deciding to own asset classes not contained in your benchmark that could cause relative underperformance due to low correlation to the asset classes in your benchmark.

Noble’s examples of other funds’ benchmarking strategies included:
GMO Asset Allocation Fund: Its benchmark is GMO’s Global Balanced Index, which is 65% MSCI All-Country World Index and 35% Barclays Aggregate Bond Index. (Note: Alternative investments were recently 16% of their total portfolio.)


Ivy Asset Strategy: At Ivy, they apparently don’t show any custom-blended benchmark for the portfolio, but instead present portfolio returns and then separately present S&P 500, BarCap US Aggregate, BarCap US T-Bill 1-3 month, and Lipper Global Flexible Portfolio returns.

I can certainly understand, in the case of Ivy, why you would want to show your performance without presenting a blended benchmark. Unfortunately, though, even if you don’t offer a blended benchmark, the industry will be sure to give you one. How else can a prudent potential investor determine if the fund’s management is adding value for its cost?

Finding The "Right" Benchmark

Some seem to think that this difficult decision of choosing a benchmark rises to the level of a conspiracy by money managers to mislead investors into thinking they are generating excess returns, by selecting an easy benchmark to beat, rather than a hypothetical “more appropriate” benchmark. But in a word of arbitrary benchmarks, of course, the difference is not always clear.

This notion of seeing the world through the lens of money managers who misuse benchmarks in order to show excess returns was reinforced to me at the recent FPA Retreat, where I spoke on the topic of tactical asset allocation. Afterwards, I had an animated discussion with a financial planner who passionately described this process, of finding the correct benchmark for money managers, as necessary to correct a fraud that has been perpetuated on the investing public. When asked how he would create a benchmark for Pinnacle’s completely unconstrained portfolio construction, he answered that he would probably analyze what we owned after the fact in a regression analysis, and then “average it out” over time in order to create the proper benchmark. His particular take was that once the “proper” benchmark is applied, most money managers will see their alpha disappear. His job, of course, was to help his clients find the “correct” benchmark.

This advisor’s approach is actually quite popular. I happen to sit on the Finance and Investment Committee of our local community college’s Foundation Board, where the majority of portfolio assets are managed by the University System of Maryland Foundation (USMF), which in turn aggregates Foundation money from 21 different Maryland universities and community colleges into one sophisticated portfolio. As a new board...
member, I was fascinated to see how the college reported portfolio returns. The portfolio is very much in the camp of an "Endowment Model" construction, with the current asset allocation being 12% Bonds and Cash, 27.7% Public equity, 12.1% Private Capital, 24% Real Assets divided between energy and natural resources and REITS, and 24% Multi-Strategy, meaning hedge funds and funds-of-funds.

How does USMF benchmark this eclectic portfolio? First, it shows an 80-20 mix of S&P 500 Index and 20% BarCap Bonds, which seems completely irrelevant to what the managers are trying to accomplish. (I think.) But, more interestingly, the managers also present a "composite benchmark" that is determined by using the asset allocation of the fund at the beginning of each month and then calculating returns for the composite portfolio, based on indexing each asset class. At the end of the month, they compare the returns of the portfolio to the composite benchmark. By repeating this process every month, they effectively rob the USMF managers of any opportunity to add excess returns by changing their asset allocation month to month, and confine the ability to earn alpha to the underlying managers in each asset class. This notion of changing the benchmark ex-post sounds very similar, to what the advisor I met at the Retreat advocated, and it also sounds similar to those who rely on performance-based style analysis to do the same thing.

In fact, Michael Kitces and I made this very point in an article penned for Advisor Perspectives in August 2010, titled, “When Active Management Matters.” Our article offered several criticisms of an article by Roger Ibbotson, et. al., that appeared in the Financial Analyst Journal in March/April of 2010 titled, “The Equal Importance of Asset Allocation and Active Management.” In the paper, Ibbotson used performance-based style analysis to reach the conclusion that 80% of fund manager returns towing to “market” returns, and the remaining 20% of returns were split 50-50 between investment policy and active management. In our response, we pointed out that for global unconstrained managers, where being unconstrained meant being free to change portfolio asset allocation, the ex-post regression analysis would grossly distort the analysis.

The Problem With Ex-Post Regression Analysis

While an ex-post regression analysis helps to understand what a fund has owned in an attempt to determine how to benchmark it, such a process creates significant problems when applied to an eclectic manager who is free to actually change portfolio policy on an ongoing basis. Such an approach can unfairly reduce the excess positive returns earned by the manager, and also potentially hide the bad decisions of a poor manager as well.

For instance, imagine a manager who owned the S&P 500 from 1996 to 1999, the Russell 2000 from 2000 to 2002, an emerging markets index from 2003 to 2008, and gold from 2009 to 2011. By picking one of the top asset classes every year for 15 years, the manager would have generated extraordinary returns. However, if the manager was benchmarked on an ex-post basis to each asset class owned in any particular year, the
manager would appear to have an alpha of 0% each and every year – because the real value the manager delivered was not generating alpha within the asset class owned relative to a benchmark, but by changing the asset class (and the ex-post benchmark along with it!) at each turn of the market cycle.

What’s more, such a manager would be indistinguishable from a second one who owned bonds from 1996 to 1999, large cap stocks from 2000 to 2002, bonds again from 2003 to 2008, and large cap stocks again from 2009 to 2011 – even though this manager would have accumulated an incredible trail of negative returns and produced radically less wealth for his or her clients. In both cases, if the managers owned their indices for any particular year, their alpha would be 0% – even though, clearly, when viewed across asset classes, the first manager generated incredible positive alpha, while the second generated similarly incredible negative alpha.

Choosing A Benchmark In The Real World

So here we are. Pinnacle Advisory Group, a portfolio manager that is completely unconstrained by asset class targets, can choose a completely arbitrary benchmark, or we can choose to allow the industry to pick a benchmark for us. The latter option seems to take the form of either (a) averaging our actual allocations ex-post and then assigning benchmark indices to each allocation or (b) using performance-based style analysis, which uses mathematical regressions to determine, ex-post, what our asset allocation “should” have been. Alternatively, we might try to benchmark to the client's financial planning goals, but in practice this communicates to the client that we have an absolute positive return benchmark, which is unrealistic and poor expectations management, and it does nothing to really measure whether Pinnacle as an investment manager is adding value relative to simply choosing to index instead. In the end, none of the options seem particularly appealing; at times, it almost seems better simply not to report a benchmark at all.

And, in point of fact, the GIPS compliance rules for performance reporting do allow us to not show a benchmark at all if we can explain why not showing a benchmark is “reasonable.” I wonder if the fact that we don’t manage money using a tired methodology based on style-boxes is considered “reasonable?” Not to mention the notion that we routinely change the asset allocation of our portfolio and have a “go anywhere” charter in terms of what we are allowed to own.

Nonetheless, it is also reasonable, as a consumer of investment management, to insist on a sensible method for comparing performance results to a benchmark, in order to evaluate how a particular money manager is performing. Unfortunately, in our case, when the portfolio is unconstrained by asset class targets, there is no easy answer of how to offer that. It seems that we must ask our clients to fully understand the limitations of the benchmarking process, in addition to fully understanding our prior investment performance in the context of a complete market cycle, and to fully understand our process for actually finding value in dangerous and volatile financial markets. Is that asking too much?
These are the pressing questions: How do you set a benchmark for an unconstrained investment manager? Does having a benchmark inevitably lead investment managers to become closet indexers? Is it really feasible to benchmark to a client's goals (e.g., 8%/year), or does that just set an unrealistic absolute return expectation for investment results? How would you evaluate a "go anywhere" manager?

At present, we at Pinnacle have found more such questions than we have answers. But we're all ears.

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