March 17, 2016

BURKE
FINANCIAL STRATEGIES
An Independent Firm

Why is benchmarking important? And confusing?

Our logical solution

A few years ago, I was sitting in an investment committee meeting for an endowment.   The question of how the endowment was doing was always first on the agenda, but was never easy to answer. Generally, performance is measured against a standard, also known as a benchmark. The endowment had a mixture of stocks and bonds. The method that they had been using was to compare the endowment returns in a proportionate way to the S&P 500 Index and to the Lehman (now Barclays) Aggregate Bond Index, two well-known indices for stocks and bonds, respectively.

At one point, the endowment moved from 50% in stocks to 70% in stocks based on the recommendation of the investment committee. Our benchmark before the change was 50% S&P 500 Index and 50% Aggregate Bond Index. After the shift in allocation, the benchmark was also shifted to 70% S&P 500 Index and 30% Aggregate Bond Index. My concern with this technique was that, while the investments were being compared to appropriate benchmarks, the shift in allocation was not being evaluated. In other words, if we moved from 50% equities to 70% at the wrong time, our benchmarking would not capture this because we had effectively moved the benchmark. It was as if we were shooting an arrow and painting the bull's eye around it.

At BFS, we have adopted a different approach. Morningstar is a company that compiles statistics and recommendations on thousands of mutual funds. Mutual funds are by definition professionally managed portfolios. Morningstar sorts and ranks mutual funds by category.

One of the broad categories is "allocation funds." These are funds that allocate between U.S. stocks and bonds, convertible bonds, foreign stocks and bonds, emerging market stocks or anything that the fund managers feel is appropriate. The funds are fully diversified, or at least that is the idea. Morningstar calculates the average return for this category, but also breaks it down into smaller categories. Three of the smaller categories are "conservative allocation," "moderate allocation," and "aggressive allocation."[2] A few years ago, we realized that the returns of these categories provide a logical benchmark for our conservative, moderate and aggressive clients.

For example, if you consider yourself to be moderate with your investments, we would compare your returns to the "moderate allocation" benchmark.   There are 981 funds tracked by Morningstar in that category (and 899 in the conservative category and 464 in the aggressive category, as of the end of 2015). We think that if, after fees, we can match that return, the average of professionally managed moderate allocation funds, we are doing a good job because we are also providing additional services, including financial planning advice, asset location advice (the allocation of assets between taxable and tax-advantaged accounts) and the hand holding that is necessary during bad markets.

The other reason we believe we are doing a good job by matching the benchmark is that most investors do not match these returns. According to a study done by Vanguard[1] over ten years ending 12/31/2013, conservative investors averaged 4.24% while the conservative benchmark that we mentioned above returned 5.06%. Moderate investors, according to Vanguard, returned 4.96% while the benchmark returned 6.06%.[3] In the same research article, Vanguard estimated that asset location advice can be worth another 0.75% per year.

When we do a review for you, we include returns of the three benchmarks so you can compare your results. This takes a lot of courage on our part. We have found very few advisors willing to place meaningful benchmarks front and center. Of course, there are times when we do not match the benchmark, which leads to a discussion of "why not?"

Management guru Peter Drucker once said that "If you can't measure it, you can't manage it." We agree, but we would like to add that after you measure it, you have to make sense of the measurement. That's why we like to benchmark.

Sincerely,

John B. Burke, MS, CFP®
President, BFS

Burke Financial Strategies (BFS) is an independent firm. Securities offered through Raymond James Financial Services, Inc. Member FINRA/SIPC.

[1]Putting a value on your value: Quantifying Vanguard Advisor's Alpha, Francis M. Kinniry Jr., CFA, Colleen M. Jaconetti, CFP®, Michael A. DiJoseph, CFA, and Jan Zilbering. March 2014

[2] **Conservative Allocation:** Conservative-allocation portfolios seek to provide both capital appreciation and income by investing in three major areas: stocks, bonds, and cash. These portfolios tend to hold smaller positions in stocks than moderate-allocation portfolios. These portfolios typically have 35% to 50% of assets in equities and 50% to 65% of assets in fixed income and cash.
Moderate Allocation: Moderate-allocation portfolios seek to provide both capital appreciation and income by investing in three major areas: stocks, bonds, and cash. These portfolios tend to hold larger positions in stocks than conservative-allocation portfolios. These portfolios typically

have 50% to 70% of assets in equities and the remainder in fixed income and cash.
Aggressive Allocation: Aggressive-allocation portfolios seek to provide both capital appreciation and income by investing in three major areas: stocks, bonds, and cash. These portfolios tend to hold larger positions in stocks than moderate-allocation portfolios. These portfolios typically have 70% to 90% of assets in equities and the remainder in fixed income and cash.

Portfolios are comprised of the average performance of multiple mutual funds and one cannot invest in these directly. Individual results will vary. Past performance does not guarantee future results.

[3] The Benchmark figures are time-weighted and represent the average fund return in each category. Morningstar Investor Return™ assumes that the growth of a fund's total net assets for a given period is driven by market returns and investor cash flow. To calculate investor return, a fund's change in assets for the period is discounted by the return of the fund, to isolate how much of the asset growth was driven by cash flow.

Investors should consider the investment objectives, risks, charges and expenses of mutual funds carefully before investing. The prospectus contains this and other information and should be read carefully before investing. The prospectus is available from your investment professional.