As the year comes to an end, it is natural to want to know your account performance. At first glance, it seems like a simple and straight forward question. However, when looking at account performance there are two items that need to be addressed. The first is account **return** and the second is the **risk** that was taken to achieve that return. In other words, we want to make sure we are comparing apples-to-apples and not apples-to-oranges. In this article, we will explain how proper account performance is conducted.

A common question we hear is "*Why is my account being compared to a Morningstar Targeted Risk Portfolio and not the S&P 500?*" This is a great question and one worth addressing, but first we would like to take a step back and answer the following questions:

- What is a benchmark?
- How do I pick a benchmark?
- Is my benchmark appropriate?

What is a benchmark?

According to Merriam-Webster a benchmark is defined as "*something that can be used as a way to judge the quality or level of other, similar things.*" In the context of investment portfolios, we care about return and risk; thus, we use a benchmark to compare the returns and risk of other similar portfolios.

How do I pick a benchmark?

The above definition has two key things to consider for picking a benchmark. First, does it provide a quantity or level that can be measured? Second, is it similar to the things I plan to compare against?

Let's tackle these questions using a car shopping analogy.

Pretend you're going to buy a new car. What are some of the things you would evaluate before making this purchase? We would be willing to bet one of the following: cost, power, efficiency, comfort, or safety.

If you're buying a sports car, and hopefully not as a first car for your teenager, you're likely going to consider things like power and speed as more important than fuel efficiency. To measure this power, you want to look at things like horsepower, torque, 0-60mph, etc.

Now imagine you're buying a first car for your teenager. Are you going to consider the same characteristics? Probably not. Most parents are not likely to want their kids first car to emphasize power and speed but would rather focus on safety and fuel efficiency.

In this analogy we have two car purchases where two different factors are emphasized. For one car, we care about safety and fuel efficiency. For the other car, we care about power and speed. Now that we know what we are measuring, we would assign a benchmark of cars to each category to help us determine how the car we want to buy stacks up against other similar cars.

Picking a portfolio benchmark is similar to this car buying example. You can pick a benchmark with more return, much like the car with more power and speed. However, this comes with the tradeoff of safety and fuel efficiency. What you don't want to do is compare a car that emphasizes power and speed to one that focuses on safety and fuel efficiency. What you do want to do is compare the sports car to other sports cars.

Is my benchmark appropriate?

This is where everything we talked about comes together. Let's assume you want a portfolio that has the highest expected return, we would then build a portfolio of 100% stocks. This is the car with power and speed in our example, more risk but a higher expected reward. However, if on the other hand you want a portfolio that emphasizes safety over return, we would build a portfolio that holds more bonds than stocks. This would be equivalent to the car you buy your teenager that focuses on safety.

If you have a portfolio that is comprised of 100% stocks, the benchmark selected should be one that also has 100% stocks. If on the other hand, if your portfolio has 60% stocks and 40% bonds, the benchmark you use should also hold 60% stocks and 40% bonds.

An inappropriate benchmark would be one that is comprised of 100% stocks used to compare a portfolio that holds 60% stocks and 40% bonds. You would be comparing apples-to-oranges here.

Summary

Let's come back to the question, "*Why my account is being compared to a Morningstar Targeted Risk Portfolio and not the S&P 500?*"

At Surevest our goal is to build portfolios that protect and grow our client's wealth responsibly. That means using fundamental techniques like proper diversification. That is why we use the Morningstar Targeted Risk Portfolios as our benchmark and not the S&P 500 Index.

The Morningstar Targeted Risk Portfolios are globally diversified portfolios that invest in both stocks and bonds where the S&P 500 invest 100% in stocks. In addition, for the stock portion of the Morningstar Targeted Risk Portfolios, it will invest in the U.S., internationally in developed markets like Germany and emerging markets like China and India. It also invests not only in large capitalization stocks, but also medium and small capitalization stocks as well. On the other hand, the S&P 500 Index only invests in U.S. large capitalization stocks.

In years when the S&P 500 is the best performing index, your accounts won't return as much, but when the S&P 500 performs poorly, your accounts are expected to do better because you will have exposure to other asset classes. It is impossible to know in advanced which markets and assets will perform the best, so we rely on what research supports which is to build globally diversified portfolios. Once we build these portfolios, we rely on our research to help us tilt the portfolio to asset classes that are likely to do well, but we make these modifications in a way that will not compromise the portfolios. In other words, we understand that we cannot predict the future and it's not our job to gamble with our client's hard-earned money.

Our mandate is to protect and grow our client's wealth responsibly, which is why we build globally diversified portfolios. Therefore, to properly look at your account performance it must be compared to a globally diversified portfolio like the ones provided my Morningstar and not the S&P 500 Index.

We hope this helps you better understand how to properly benchmark your account performance, but should you have any questions, please contact your financial advisor.