
# ACG Insights: Benchmarking

***bench'mark - a standard or point of reference against which things may be compared or assessed.***
*Source: Merriam-Webster*

## Introduction

We believe using the right benchmark is essential throughout the portfolio management process. Benchmarking acts as the risk guardrail for the portfolio, but it also sets the groundwork and serves as a constant reference point for both managers and the overall portfolio. Every benchmark offers a way of translating a portfolio's objective to an actual allocation, ensuring that goals are considered in conjunction with expectations for market returns. Proper benchmarking also plays a role in each of the subsequent steps of the portfolio construction process.

## How are benchmarks constructed?

As stated by the CFA Institute, benchmarking should reflect five key areas. A benchmark should:

1. Accurately and objectively reflect the full set of investable opportunities for a well-defined asset class, whether that is in equities, fixed income, or alternative securities
2. Be replicable and investable so than an investor choosing the benchmark can be assured that the actual behavior of the asset class is reflected
3. Be current and reliable in that it remains consistent and up to date
4. Balance the interests of all users
5. Seek to minimize the costs of replicating that benchmark in order to support investment efficiency

Benchmarks often differ in terms of market capitalization, style (growth vs. value), and geography. For instance, the stocks in the S&P SmallCap 600 Index must have a capitalization between $400 million and $1.8 billion whereas the Russell 2000 Small Cap Index is comprised of the smallest 2000 stocks in the Russell 3000 Index. These capitalization differences apply across large, mid, and small cap indices within the value and growth style boxes as well. Thus, there are periods of time where each index can differ in return, but over long periods of time they tend to have a very high correlation to each other.

Below are detailed comparisons of the methodologies used by leading benchmark providers.

| | S&P | Russell | MSCI | CRSP | Dow Jones |
|---|---|---|---|---|---|
| **Main Focus** | Domestic Equity | Domestic Equity | Global Equity | Domestic Equity | Domestic Equity |
| **Example Indexes** | S&P 500<br>S&P SmallCap 600<br>Value Indices<br>Growth Indices | R1000<br>R2000<br>Value Indices<br>Growth Indices | MSCI ACWI<br>MSCI ACWI ex-US<br>MSCI EAFE<br>MSCI EM | CRSP Large Cap<br>CRSP Total Market<br>CRSP Mid Cap<br>CRSP Small Cap | DJ Industrial Average |
| **Construction** | Committee | Rules-based | Rules-based | Rules-based | Rules-based |
| **Weighting** | Float-adjusted Market Cap | Float-adjusted Market Cap | Float-adjusted Market Cap | Float-adjusted Market Cap | Full Market Capitalization |
| **Rebalancing** | As needed | Annual | Quarterly | Quarterly | Quarterly |
| **Growth Criteria** | • Hist. 3y Rev/ EPS growth<br>• Hist. 12m Momentum | • Consensus med. Term EPS growth<br>• Hist. 5y Rev. growth | • Consensus EPS growth / IRR<br>• Long term hist. EPS trend<br>• Long term hist. Rev trend | • Consensus EPS growth forecast<br>• Hist. 3y Rev/EPS growth<br>• ROA | • Fwd. P/E<br>• Proj. EPS growth<br>• P/B Ratio<br>• Yield<br>• Rev/EPS growth |
| **Value Criteria** | • P/B Ratio<br>• P/E Ratio<br>• P/S Ratio | • P/B Ratio | • P/B Ratio<br>• Consensus EPS growth forecast<br>• Yield | • P/B Ratio<br>• Hist. Rev/EPS<br>• Yield | • Fwd. P/E P/S Ratio<br>• P/B Ratio, Yield<br>• Hist. Rev/EPS |

*Source: Vanguard*

While performance of similar benchmarks tends to be correlated over full market cycles, understanding index construction can play a critical role in dissecting shorter term differences.

For example, our research revealed two primary drivers of the consistent outperformance by the S&P SmallCap 600 versus the Russell 2000.

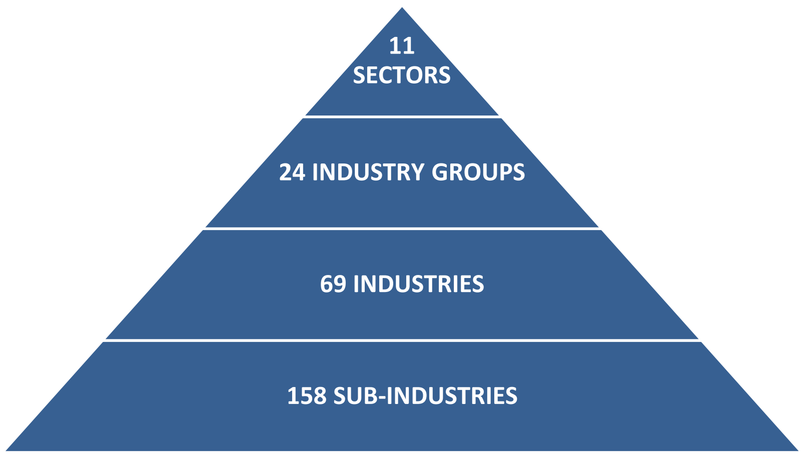
1. S&P requires that eligible companies pass a “financial viability” test measured by positive as-reported earnings over the most recent one and four quarters summed together; and
2. S&P’s index reconstitution occurs only on an “as needed” basis. It does not go through the annual process Russell implements which is predictable, extensive, and creates the opportunity for market participants to “front run” some trades.

These two distinguishing attributes tend to give the S&P SmallCap 600 Index a higher quality and defensive profile relative to the Russell 2000 Index.

### Why are public companies divided into sectors?

Sectors are intended to represent subdivisions of the equity universe in which each stock is assigned to one (and only one) category and each category represents a material portion of the investment universe. The basic goal is to have a high degree of commonality among the business models of stocks within a sector and a high degree of differentiation among the business models of stocks in different sectors. While these divisions will always be a bit arbitrary, the end goal is to have a grouping of stocks that will move somewhat in parallel with economic conditions and whose members are suitable comparisons with other members of the same sector.

The Global Industry Classification Standard (GICS) is a standardized classification system for equities jointly developed by Morgan Stanley Capital International (MSCI) and Standard & Poor's. The GICS methodology is used by the MSCI indexes, which include domestic and international stocks, as well as by a large portion of the professional investment management community. The GICS hierarchy starts with 11 sectors and breaks down into 24 industry groups, 69 industries, and 158 sub-industries. Each stock that is classified has a coding at each of these four levels.



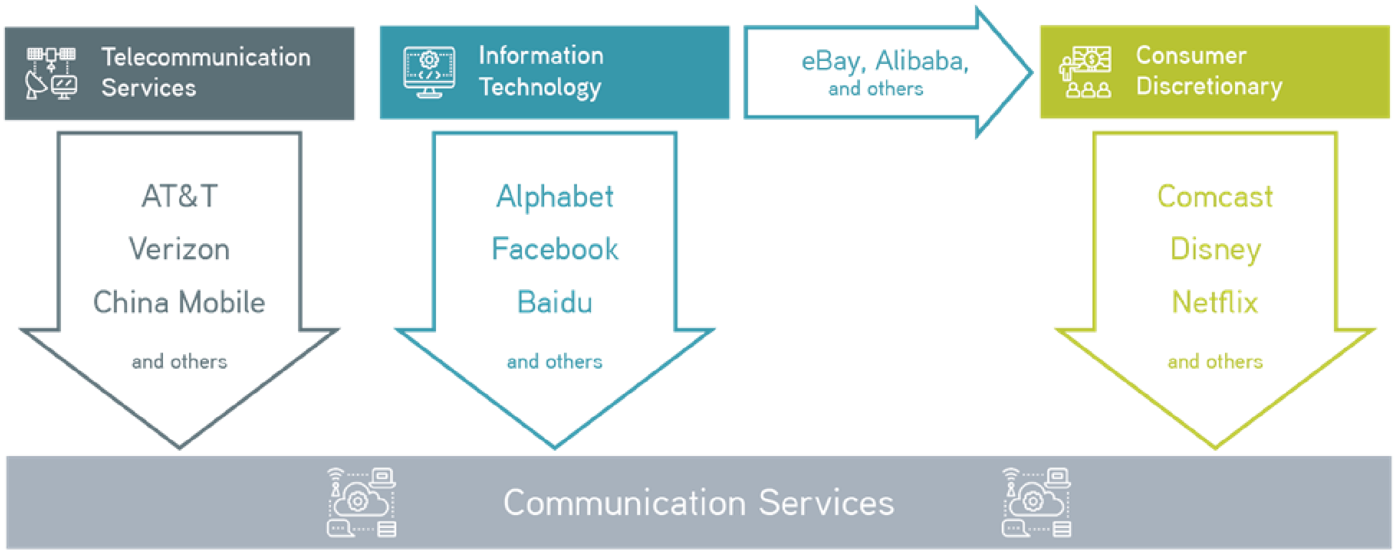

*Source: MSCI*

### What happens when benchmarks change?

In some instances, the underlying constituents of a benchmark move as their businesses evolve. On September 28, 2018, the Global Industry Classification Standard (GICS) made its biggest structural change so far; the Telecommunication Services sector broadened significantly and was renamed 'Communication Services'. This change reflects the fact that the way people communicate, share information, and entertain themselves has significantly and fundamentally changed as a result of the rapid convergence between technology, media, and telecom. Companies responded to this changing dynamic by bundling many services such as cable, internet, and telephone.

While this may seem like a minor tweak to an arcane process, investors should understand the motivation for these changes since it affects major publicly-listed technology companies. It is also important to be aware of the portfolio management implications since active sector bets such as an over or underweight investment in technology companies relative to the benchmark may change radically because of these newly defined sectors.

**What are the proposed GICS sector changes?** The Telecommunication Services sector was expanded and renamed Communication Services. Media companies such as Netflix, Comcast, and Disney moved from Consumer Discretionary to Communication Services. Additionally, internet services companies such as Facebook, Google, Tencent, etc. moved from Information Technology to this newly renamed sector. Finally, ecommerce companies such as eBay and Alibaba moved from Information Technology to Consumer Discretionary.




*Source: MSCI*

**What is the impact on my portfolio?** These changes will have zero impact on fully replicated index funds since every name is held close to index weights. For some actively managed strategies, the potential exists for sudden unintended shifts in the active sector if the investment mandate allows for deviations from the benchmark. An extreme example: An active manager who had held only Facebook and Google to represent the Information Technology ("IT") sector would, because of the GICS changes, now hold zero exposure to IT.

Nearly 8% of the S&P 500 companies are affected by these changes. This may seem like a major change, but it is not unlike industry changes we have experienced in the past. For example, as technology evolves the importance of certain industries has transitioned from one to another (e.g. railroads to airlines). We've studied the impact of these sector reassignments on our client portfolios and preliminary indications are that we should see little to no impact arising from these sector changes. Our initial assessment indicates that the new security classifications result in changes that fall within these tolerances for most strategies.

**The bottom line.** These GICS sector changes were long overdue. We believe the changes will provide greater clarity and accuracy into how companies are grouped. This should ultimately increase the effectiveness of how portfolios are managed. That said, it's worth examining how the changes could affect your overall portfolio—and to be prepared to reexamine your sector allocation under the new paradigm.

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