

## Which benchmark really matters?

When SEAMARK was launched some 30 years ago, performance was largely viewed in relation to that of other investment managers. By definition, half of the field would be winners (above median), and the other half would be below. This dividing of the pack was an effective way of keeping money managers focused on performing. The growth of many great investment management firms was a consequence of sustainably delivering industry leading performance.

Over time, index benchmarks entered into the discussion, often by way of the client's Investment Policy Statement. Many in the money management industry acquiesced to the use of index benchmarks. It would be easier to beat a 'dumb bogey' than the returns of the top half of the investment manager pack, was the thinking at the time. Active money managers recognize that benchmarks have many inherent shortfalls that cause managers to want to rebuff their adoption. Benchmark agnostic is a phrase we have used from time to time, suggesting that we can do better for the client with our active management. Better, doesn't have to mean beat the benchmark. In Canada, the S&P/TSX Composite Index is a poor standard to have as a benchmark because it so heavily skewed toward just two dominant sectors, with financials and commodities collectively accounting for approximately two-thirds of the Composite.

SEAMARK has been quite vocal, warning investors, institutions and individuals alike, to be leery of the default level of risk (or volatility) inherent in this lopsided Canadian industry standard. In fact, in response, we have even developed a specific investment solution to squeeze out as much volatility as we can from the investment equation by managing a Low Volatility Equity portfolio, which we offer to those investors that seek a smoother investment experience.

Every investment management search considers a prospective manager's investment style. There are several types of managers e.g. value managers, growth managers, and growth at a reasonable price managers. There are index managers, and momentum managers. Each of these styles carries a connotation to the observer. People recognize Warren Buffet as a value manager. Ben Graham (the grandfather of fundamental analysis) was the same. So value has a positive connotation: Buy low, sell high.

What style would one ascribe to an index of stocks? One may think that an index is style neutral, but that is not the case. By contrast to Buffett and Graham, most indices fall into the momentum style. And momentum has the opposite connotation to value, because it has the effect of buying high, buying more, higher, and selling low. With absolutely no regard for price or value. This sounds counterintuitive to the goal of investing, but it is an inescapable fact of the arithmetic behind the construct of capitalization-weighted indexes. Meanwhile, the prudent manager is doing just the opposite...trimming, or selling holdings on the way up when they represent overvaluation, and adding to, or purchasing when prices are down and represent real opportunity. You would expect the performance profile of such a manager to underperform the index on the way up, and outperform, on the way down.

In the discussion of Index benchmarks, there is another fiduciary consideration to contemplate. It is generally accepted that the market, based on its depth and breadth, represents the average of all companies. The index consists of big companies, and small companies; fast growing companies and slow growth companies; good companies, and bad companies...all rolled up to represent some average. In defence of active management, SEAMARK's founder Peter Marshall used to retort to those that espoused the use of indices: "Why do you want to own the bad companies too?"

Now, what of the investor participants? Do they fit an average profile? There are the young, and old. The experienced and inexperienced. Speculators and investors. The well capitalized, and the undercapitalized. The cash flow positive, and cash flow negative. The private client and the institution. Each with their own risk taking abilities. Is the index a one stop benchmark solution for such a disparate group of participants? How does an investment manager exercise a fiduciary duty to create a properly risk-tuned portfolio for such a diverse group of investors, if each one adopts the index as a benchmark? Someone is being under-served by that model.

In creating an efficient portfolio that will reflect a lower tolerance for risk, we opt for a collection of securities that we expect will deliver attractive returns, but with less volatility than the index, i.e. less downside capture than the index. As practitioners of active money management and the fiduciary duty that entails, we object to the notion that Index benchmarks should be considered as neutral, or as a default, or universally acceptable in any way. Clients deserve better, and we strive to deliver that!

Robert G. McKim, CFA | Chief Investment Officer

1. <http://www.theglobeandmail.com/report-on-business/the-logic-and-lunacy-of-calculating-the-inflation-rate/article25008805/>
2. (Figure 3) <http://www.economics.utoronto.ca/jfloyd/modules/infl.html>
3. [http://www.shadowstats.com/alternate\\_data/inflation-charts](http://www.shadowstats.com/alternate_data/inflation-charts)