Keeping Score with Portfolio Weighted Returns

A portfolio's absolute return is measured by evaluating how securities perform over time. An important question is: "how is a portfolio performing relative to other portfolios?" This process is called benchmarking.

Whether your attentiveness to how your investments are performing ranges from anxious to passive, an important question is which benchmark to use. For example, should our benchmark be the Dow Jones Industrial Average, the Standard &. Poor's 500, or some other index? The Dow Jones Industrial Average is an index of 30 of the largest US companies, and the S&P 500, while a broader measure, reflects the performance of the 500 largest US stocks. Nevertheless, both of these indices reflect only a small segment of a large market. Also, the indices we see often quoted in the press do not account for dividends on those stocks although account or portfolio performance is customarily measured by "total return" which includes dividends and interest.

Seldom do the electronic media or large city newspapers cover the performance of other capital markets or categories of assets which are not only vital for diversification — and risk reduction — but also significant in an increasingly global economy: emerging market stocks; European stocks; real estate investments; US corporate bonds; government bonds, small company stocks, to mention a few. To measure the performance of a diversified portfolio (one which includes cash, bonds and equity investments) many indices must be used to provide meaningful comparisons.

In our firm, after selecting the appropriate indices, we allocate them in proportion to their representation in a client's portfolio. Once this is done, a simple multiplication of each index by its allocation and a final addition of the results provides a true picture of how the portfolio as a whole is doing. We have provided the 1995 performances of indices covering a range of assets normally employed by our firm, along with the percentages of a sample portfolio invested in the asset classes represented by those indices.

INDEX RETURNS (1995)			SAMPLE PORTFOLIO WEIGHTINGS		BENCHMARK WEIGHTED PORTFOLIO RETURN
3 Month Treasury Bill	5.51%		US Small Company Value	15%	
LB Corporate Bonds	22.24%		US Large Company Growth	10%	
LS Government Bonds	18.33%		Emerging Market Stocks	12%	
LB All Country Bond	15.73%		International Stocks	13%	
Wilshire REIT Index	12.24%	X	Real Estate	5%	= 16.83%
MSCI International EAFE	11.20%		World Bonds	15%	
MSCI Emerging Markets	-10.74%		Government Bonds	15%	
Wilshire Large Cap Grth	37.88%		Corporate Bonds	15%	
Wilshire Small Cap Value	29.75%		Treasury Bills	5%	

The portfolio-weighted return of the indices allocated above is 16.83%. Let's assume the client's portfolio performed exactly like this. While it isn't close to the S&P 500 return of 37.72% in 1995, it is better than double the historical average rate of return for a similar portfolio over the last 65 years -- of about 8%. And this sample client didn't take the risk of having all his eggs in one basket. More on the reasons for diversification and allocation to tame risk in our next letter…

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