

DO BENCHMARKS MATTER?

Much has been written of late on performance measurement and comparison. It is also heartening to see a greater awareness of risk-adjusted return judging by the increasing number of published articles on the issue.

The 2 popular methods of risk-adjusted return are the Risk/Reward Ratio and the Information Ratio. The Risk/Reward measures risk adjusted return on an absolute basis, thus making a benchmark irrelevant. The Information Ratio, on the other hand, is a risk-adjusted return measure, which is relative to a benchmark. Therefore it is crucial that an appropriate benchmark be used in the calculation of the Information Ratio for it to be a valid indicator of the true risk-adjusted return of the fund.

The Information Ratio can be applied to all types of funds with differing objectives and strategies. For example, the Information Ratio of a fund which is invested primarily in equities should be adopting an equities index as the benchmark, whilst a fund investing only in bonds, a bond index.

There are also funds, which employ aggressive tactical asset allocation between multiple asset classes (for example equities and cash, or between equities, bonds and cash) in addition to stock selection for their value-added. For such funds, the more appropriate benchmark could be either a composite benchmark or, for more aggressive funds, an absolute return, say 8%, as a benchmark.

The use of a 'peer group' benchmark is common among some international independent surveys of unit trust funds in their calculation of the Information Ratio. The rationale is that it is much easier to do this as different funds seem to have different benchmarks. This argument may be acceptable for balanced, absolute return, dynamic asset allocation and global funds, but may be disputable for Malaysian equities funds.

The KLSE EMAS Index which has all the stocks on the KLSE should be preferred for all 'equities growth' funds as it is unlikely that 'growth' funds will limit themselves to the hundred stocks in the KLSE Composite Index. There are currently no other benchmarks being used for generic Malaysian equities (not counting technology, Islamic and sector indices) except for the KLSE EMAS and the KLSE CI.

Moreover, for this approach it is imperative that the peer group in question is comparable in the same category, not just in terms of

labeling, but also that they are true to their label. If there are some funds in a category which although defined as 'equities growth', are substantially invested in bonds, cash or limited to a particular sector, this will no doubt skew the peer benchmark itself. Correspondingly the Information Ratio calculations of all the funds in that category will be questionable as a reflection of an equities growth mandate.

There are some investors who are looking for funds where the active asset allocation is left to the fund manager's discretion. Such investors should be shopping in the 'balanced fund', 'dynamic asset allocation' and 'absolute return' categories. In such categories, the peer group benchmarks are acceptable.

However, for investors who are more confident in doing their own asset allocation and are searching for 'best of breed' funds within the pure asset categories such as 'equities'/'equities growth' or 'bonds', using the peer group benchmark for the calculation of the Information Ratios can become problematic.. They could be cheated out of exercising this choice as there are no publicly available rankings and Information Ratio calculations for equities or bond funds relative to the purer equities and bond indices respectively. As such, they could unwittingly be investing in a balanced fund, a pseudo-bond fund or a dynamic asset allocation fund whilst thinking they have chosen a top 'best of breed' performer within an equities or bond category. This would also pose a problem for independent financial advisers who are already advising their clients on asset allocation and trying to select funds which are truly either equities or bonds.

The locally available performance tables for unit trust funds has at least made some progress in moving from absolute returns to risk-adjusted returns. However the industry performance tables could do with further enhancements such as the following:

- 1) the KLSE Emas Index can be used instead of the peer group benchmark for calculation of the Information Ratio for the 'Equities' and 'Equities Growth' category.
- 2) More due diligence on the categorization of funds to ensure like-with-like comparison

We believe that the investment industry still has some way to go towards greater transparency to cater to the different needs of investors in the market place which will facilitate more informed investor choices. However to this end, we remain committed.

[The above article was contributed by AmInvestment Management Sdn Bhd, a member of the Malaysian Association of Asset Managers](#)