

Avoiding the Benchmark Trap



In a recent issue of Barron's, a money manager was quite critical of a particular stock but said he owned it, although he was underweighted. Comments of this kind from portfolio managers have grown so familiar that they pass by us almost unnoticed.

In truth, they ought to set off alarm bells. Every portfolio manager has a fiduciary responsibility to try to preserve client capital and generate positive returns over time. Why would an "active" manager who is deeply skeptical about a company's prospects own any of its shares at all? Why does the mere inclusion of a company or an entire economic sector in a market index make it a worthwhile—or an obligatory—investment? At First Eagle Investment Management, we believe the answer is the benchmark trap.

In this paper, we examine the damage that benchmark-dominated investing has inflicted on institutional investors' portfolios and cite evidence that the awareness of these negative effects is growing. We conclude by outlining what we feel are the advantages of absolute-return-oriented, benchmark-agnostic strategies.

The emergence of benchmark-dominated investing

Over time, stock market indices have served a variety of purposes. The Dow-Jones Industrial Average, for example, was launched in 1896 to track how well U.S. industry was performing. It was not until the 1960s that stock market indices—especially the S&P 500—began to play a new role as benchmarks for measuring portfolio manager performance. In 1968 A.G. Becker, a Chicago investment bank that had acquired an early mainframe computer, introduced its Green Book tables comparing the performance of institutional investment managers to the relevant market indices. The Green Books demonstrated that with the application of sufficient computing power, indices could be a good yardstick for measuring manager performance.

In the succeeding decade, the bear market of 1973-4 and the passage of ERISA in 1974 spurred changes in the institutional investment management business that gave benchmarks a more sweeping role. Going into that period, large banks dominated the investment management field, and many of them converged on the same “Nifty Fifty” stocks—large-cap U.S. growth stocks that were considered solid buy-and-hold investments. When the market crashed in 1973, the overvalued Nifty Fifty led the way down. Because different managers’ portfolios overlapped to such a high degree, institutions had excessive concentration in the Nifty Fifty stocks, and they suffered considerable losses. In the aftermath of the bear market, pension plan sponsors and other institutional investors were eager to find a smarter approach to investing.



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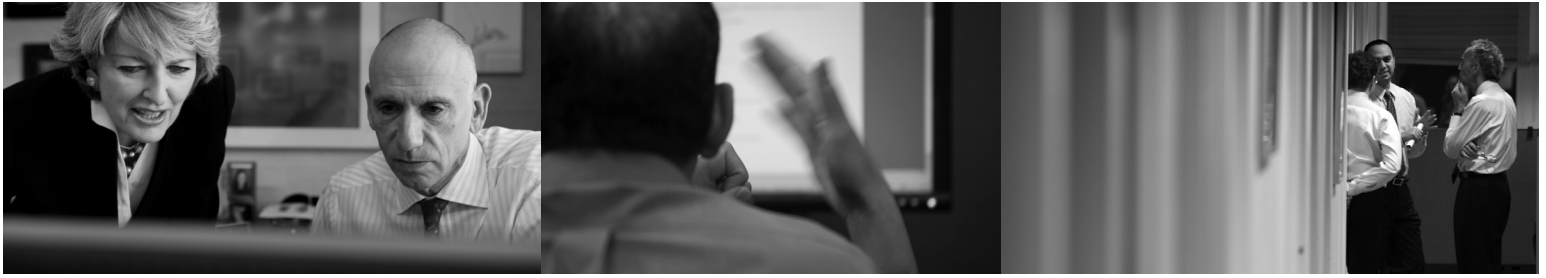
In the same period, ERISA spelled out for pension plan sponsors certain principles of prudent investing that, as fiduciaries, they were obliged to observe. Among the requirements: diversification of investment holdings and due diligence in the selection of appropriate asset management firms. Measuring prospective or incumbent managers’ investment performance was clearly among the dictates of prudence.

In combination, these factors led to a transformation of the investment management business. While banks and other large institutions remained important players, numerous investment management boutiques sprang up, each specializing in a limited number of asset classes and investment styles. And between institutional clients and the asset managers who would serve them arose gatekeepers—investment advisors and pension consultants—who took responsibility for asset allocation decisions and for evaluating and tracking investment management firms. Managers were hired for specific mandates within an institution’s investment portfolio, and each was measured against an appropriate benchmark. “Style drift” was considered a serious offense because it could lead to overlap with other managers’ mandates and could result in excessive portfolio concentration—a departure from the institution’s overall asset allocation strategy.

In this system, benchmarks came to play a damaging role—not just as a measuring device, but as a driver of investment decisions. In the case of passive funds, otherwise called index funds, this is entirely expected. But active funds presumably represent rational investment decision-making. Why, then, would “active” investment managers purchase some stocks solely because they are included in a benchmark, even if they recognize those stocks as being significantly overvalued?

Perhaps the primary reason is the simple desire of investment managers to retain assets under management by staying within their designated style box and avoiding the risk of significant short-term underperformance. In a marketplace obsessed with quarterly returns, portfolio managers who hew closely to their benchmark index may be trying to protect their assets under management, their bonuses and possibly their jobs—even if doing so undermines their ability to deliver truly superior performance. In other words, they may be engaging in rational irrationality, which has been defined as “behavior that, on the individual level, is perfectly reasonable but that, when aggregated in the marketplace, produces calamity.”¹

¹ John Cassidy, “Rational Irrationality,” *The New Yorker Magazine*, October 5, 2009, pp.30-35



The benchmark trap during market bubbles

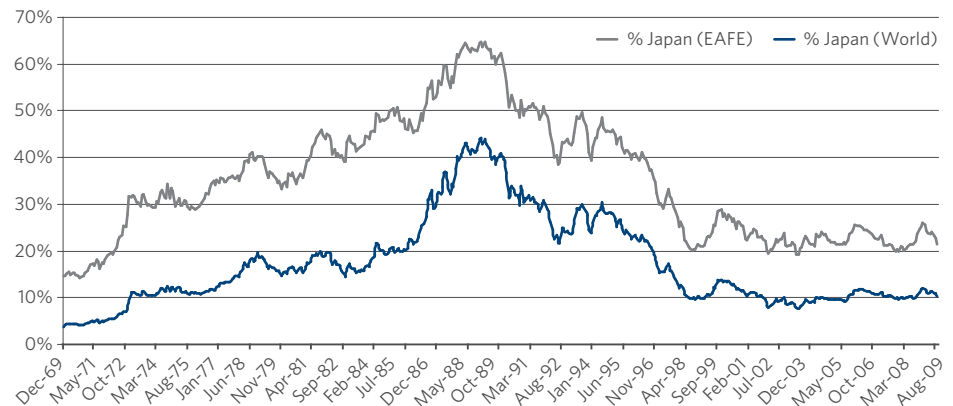
The calamitous effects of the benchmark trap are especially evident during periods when securities markets are gripped by speculative bubbles or manias. Bubbles have been a feature of markets for centuries, and in the past two decades alone, the equity markets have passed through at least three significant bubbles: in Japanese stocks in the late 1980s; in TMT (telecom, media and technology) stocks in the late 1990s; and in financial stocks more recently. As each of these bubbles inflated, it came to dominate the relevant market indices.

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From the end of 1985 to the end of 1989, Japan's Nikkei 225 Index climbed at an average annual rate of 31% and the Japanese stock market tripled in value. The average price-to-earnings ratio of Japanese stocks was 21 in the first half of the 1980s, but it was consistently above 40 in the second half. As the chart below illustrates, in January of 1989, Japanese stocks constituted 64.68% of the MSCI EAFE Index and 44.00% of the MSCI World Index. The bubble began to deflate in April of 1990 and today, Japan represents just 22.07% of the MSCI EAFE Index and just 10.11% of the MSCI World Index.

Japan Dominated Stock Indices

December 1969 - September 2009



Data Source: MSCI

As a result of the benchmark trap, many relative-return oriented global and international managers may have felt compelled to load on Japanese stocks at higher and higher prices during the late 1980s. Even if they believed that companies in Japan were vastly overvalued, the fear of drifting “too far from the herd” may have prompted them to maintain a significant exposure to Japan. This kind of buying in itself contributed to the bubble’s expansion. Long-term benchmark-agnostic investors, however, were resisting the tug of the herd. Regardless of what the “herd” was buying, they were not tempted to buy overvalued Japanese stocks.

Similarly, in the second half of the 1990s, large-capitalization U.S. growth stocks in the TMT areas soared in value. As typically occurs during market manias, many observers and participants insisted that this was no bubble at all, but that the emergence of the internet signaled a “new economy” and a “new paradigm” for investing, as well as for business.

Old-fashioned price-to-earnings ratios, market-to-book ratios, dividend yields, and discounting net cash flows were not applicable because these companies did not have earnings (nor pay dividends) and were not expected to have earnings (nor pay dividends) in the years to come. In fact, the existence of earnings was seen as a negative, demonstrating a lack of entrepreneurial aggressiveness and commitment. Very often, valuations were based on such imaginative concepts as customer growth, web site visits, peer group comparison, “engaged shoppers,” and “leading mind share...”²

The current decade saw a mania for financial stocks, including many “black box” institutions whose sources of profitability were neither visible nor comprehensible to most investors.

At the height of the dot.com mania in March 2000, TMT stocks constituted 42.67% of the S&P 500 Index. It is reasonable to think that a relative return manager who was bearish on the TMT space in this period could have maintained over a third of his portfolio in such names. Once again, however, long-term benchmark-agnostic investors said, “No.” After the bubble popped in 2001, TMT stocks in the S&P 500 proceeded to return -17% over the three year period ending at the close of March 2004. As of September 30, 2009 they accounted for just 24.46% of the S&P 500 Index. Meanwhile, the tech-heavy NASDAQ Composite Index, which touched 5,132 in March 2000, fell to 1,423 in September 2001 and has not broken 2,900 in the years since then.

The TMT Bubble/NASDAQ Composite Index

November 30, 1984 - March 31, 2010 (Daily)



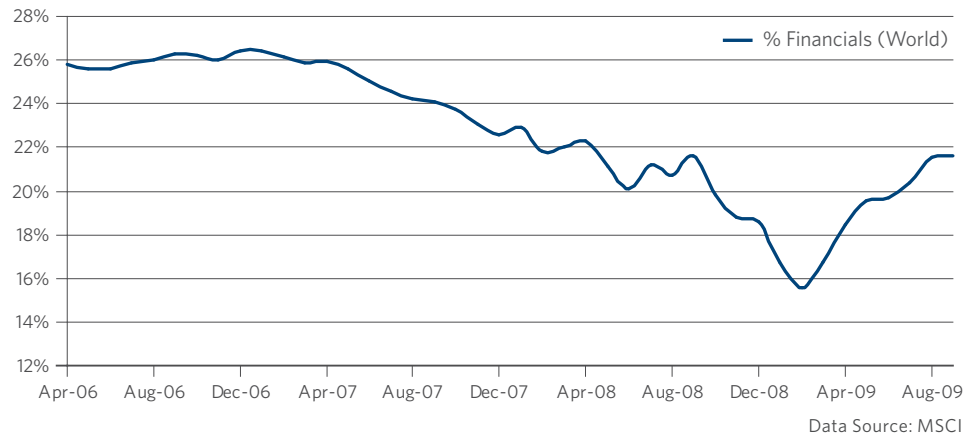
Data Source: Price History -IDC/Exshare ©FactSet Research Systems 2010

The last decade saw a mania for financial stocks, including many “black box” institutions whose sources of profitability were neither visible nor comprehensible to most investors. As the chart on the following page shows, the financial sector climbed to 26.44% of the MSCI World Index at the start of 2007, before falling back to 18.58% by the end of the following year. Relative-return-oriented portfolio managers kept their sector allocations within a narrow band around a benchmark due to the pressure to avoid deviating too much from it. During this bubble, however, buying the current glamour securities was a choice made even riskier by the fact that, in many cases, they were buying stocks they did not understand.

² “The Valuation of High-Tech “New Economy Companies,” Xu, Lianzan, *Global Competitiveness*, January 1, 2005 [<http://www.allbusiness.com/specialty-businesses/601847-1.html>]

Financial Sector in MSCI World Index

April 2006 – September 2009



Buying overvalued securities can cause deep and irreparable harm to a portfolio. Once popped, asset bubbles do not re-inflate. Unlike portfolio losses that result from short-term earnings-related fears, the losses caused by purchasing securities at grossly inflated prices often leads to permanent impairment of investor capital.

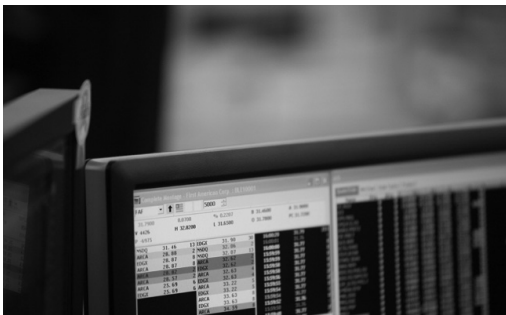
A skewed definition of risk

A second potentially damaging effect of the benchmark trap is the tendency to measure performance on a relative basis. For example, if a market benchmark is up 40% and a portfolio is up only 25%, the portfolio has underperformed on a relative basis by 15%. Likewise, if a market benchmark loses (40%) and a portfolio loses only (35%), the portfolio has outperformed by 5% and some would conclude that the manager deserves a reward for this achievement.

In truth, these two situations are not remotely comparable. In the first scenario, the manager may be protecting client assets over the long term by refusing to participate in an inflating market bubble. In the second scenario, there is a potential for permanent loss of capital that will affect the portfolio regardless of its performance relative to the benchmark. Relative outperformance provides little comfort to the institution that holds the portfolio. Retirees will not accept relative returns in lieu of their pension checks, college professors will not accept relative returns in place of their salaries. To meet its obligations, a pension fund, an endowment or a foundation should consider absolute returns.

Investment managers who build portfolios to mirror that of a benchmark do minimize the risk of relative underperformance, but in the process, they effectively outsource a portion of their investment judgment to, for example, the committee at McGraw Hill that maintains the S&P 500 Index—or to equivalent bodies at MSCI and elsewhere. This can have several undesirable consequences. In addition to the tendency to buy rather than avoid high-priced “glamour” stocks, it also means that these investment managers often do not take full advantage of their best ideas. A large investment in an attractive out-of-benchmark opportunity could result in too much benchmark-related risk or style drift, even if it would be the best choice for clients.

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Furthermore, in our view, when risk is not defined in terms of permanent loss of capital, but rather in terms of deviation from a benchmark, the overall risk to investors increases. Because they limit themselves to a narrow set of assets—even in periods when the risks associated with these assets are exceptionally high—benchmark-sensitive managers will ignore out-of-index assets whose historical returns are negatively correlated with overall market conditions and may provide downside protection.



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Cash is one example of an asset that equity investors have been discouraged from holding as a result of the benchmark trap—a portfolio construction approach that increases the probability that the managers will deliver negative outperformance when markets correct. In other words, relative-return investing and the concept of “style-box discipline” have forced investment managers to minimize the amount of cash that they hold in order to minimize deviations from the index. This in turn maximizes the exposure to the largest (and many times, most expensive) sectors and/or countries, because the manager has to either scale up positions or equitize cash in order to be fully invested.

Thus, it is our view that to the extent investment managers are influenced by benchmarking, the results will likely be lower returns with increased levels of risk.

Growing awareness of the benchmark trap

In the current investment climate, a number of market observers have highlighted the drawbacks of relative-return-oriented investing.

In 2006, Martijn Cremers and Antti Petajisto of the Yale School of Management published “How Active is Your Fund Manager?” which offered a new tool, Active Share, for measuring the extent to which a portfolio’s stock selection diverges from its benchmark index. The authors found that portfolios with the highest Active Share outperform their benchmarks by a solid margin.

In 2008, Randy Cohen of Harvard Business School, Christopher Polk of the London School of Economics (LSE) and Bernhard Silli of Universitat Pompeu Fabra and LSE published “Best Ideas,” a paper that provides evidence that mutual fund managers can select stocks that outperform the market. The authors conclude:

First, the U.S. stock market does not appear to be efficiently priced, since even the typical active mutual fund manager is able to identify a stock that outperforms. Second... the organization of the money management industry appears to make it optimal for managers to introduce stocks into their portfolios that are not outperformers, even though they are able to pick good stocks.

Publications from outside academia have picked up the same theme. In October 2009, the Financial Times published an article by John Authers called “Triumph of common sense over benchmarks,” which offers this view of the future:

Rather than watch everyone herd towards benchmarks, while charging fees for active management, in the future perhaps a lot of money will be managed passively and the rest will be allocated to investors who can show they have skill, and who have the freedom to go wherever they believe they can profit.

We believe that many factors have converged to prompt these challenges to benchmark dominance

- The markets' steep plunge in 2008 and early 2009 called into question fundamental market theories and practices;
- The efficient market hypothesis has lost many of its adherents;
- Institutional investors who suffered significant losses despite outperforming a benchmark have begun to question the standard industry approach to measuring investment risk;
- In an era of more modest return expectations, investors want to be sure that active managers are actually earning their fees;
- The proliferation of hedge funds in recent decades opened many investors' eyes to the benefits of absolute-return-oriented investment strategies.

A better alternative

We believe that an investment manager who is dedicated to the preservation of client capital and who is focused on generating positive absolute returns over time may invest in ways that differ significantly from capital market benchmarks. This typically entails looking for opportunities in stocks undervalued by the majority of investors.

Realizing these gains, however, requires patience. While it is not always possible to forecast when a company's true economic value will be reflected in its share price, we believe that at some point the market will recognize a stock's true value. As Benjamin Graham wrote, "In the short run the market is a voting machine, but in the long run it is a weighing machine."

Because investment management firms are currently evaluated on the basis of short-term performance, benchmark-agnostic managers do face a serious challenge. It can be difficult to reconcile benchmark-agnostic investing with the normal demands of running a business. While a bubble is inflating—a process that can take years—long-term investors who resist its lure will underperform industry benchmarks quarter by quarter, and they will almost certainly experience a net outflow of assets under management. Revenues and profits will shrink. These are losses that some firms are unable or unwilling to sustain.

However, firms where owners and portfolio managers have invested substantial personal assets in their strategies occupy a different position, in our view. In these firms, the desire to preserve wealth and the prospect of potential long-term portfolio gains outweighs the pain of short-term revenue losses. In firms such as these, portfolio managers' interests are closely aligned with those of their institutional clients. The firms and their clients measure success by the same standard: long-term positive absolute returns.

Investors' emerging concerns about the benchmark trap and interest in benchmark-agnostic strategies are welcome developments, but the underlying concepts are not new. There are investment management firms that have believed for decades that relative-return-oriented strategies potentially increase investment risk and reduce returns. For decades they have chosen securities without reference to any benchmark. These investment managers select what they consider to be only the best opportunities—securities with the potential to deliver real returns while also seeking to limit downside volatility. This approach sometimes requires a firm to ignore hot sectors, hot countries and/or glamour stocks and to go against the herd, but over the long term we believe it may help in creating the attractive absolute returns that are more appropriately suited to the payout requirements of institutional clients.

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About First Eagle

First Eagle Investment Management is an independent, closely held firm with approximately \$41 billion in assets under management and a heritage dating to 1803. Over its long history, the firm has helped its clients to preserve capital and earn attractive returns through widely varied economic cycles—a tradition that is central to its mission today. For more information visit www.feim.com.



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