

# Evaluating Portfolio Performance

When reviewing the performance of your portfolio or an investment manager, you may wonder whether it's better to evaluate the performance of your investments relative to their respective benchmarks, or to measure the absolute performance of your portfolio against your specific investment goals. While it may be tempting to focus on one to the exclusion of the other; incorporating both evaluations can provide the most effective assessment of the performance of your investments, and better assist you in meeting your long-term objectives.

## Quantitative and qualitative measures

When evaluating the performance of a portfolio managed by an investment manager, for example, there are several return and risk measurements that can be used to compare the manager's performance relative to broad-based market indices, style benchmarks and the manager's peers. While performance is critical, risk is also an important factor in assessing how their performance is being achieved.

Broad-based market indices – such as the S&P/TSX Composite Index, S&P 500 Index and MSCI World Index – are often used as a starting point; however, they do not necessarily account for the investment style of a manager. Therefore, the use of style-specific benchmarks – such as the Russell Canada Value/Growth Index for Canadian equity, the Russell 1000 Value/Growth Index for U.S. equity, and the MSCI World Value/Growth Index for global equity – in investment manager evaluations allows you to isolate a manager's stock picking ability, and ensure they're not penalized in your evaluation should their investment style currently be out of favour.

Additional quantitative measures also allow you to gauge the effectiveness of an investment manager over time. These include:

- **Upside and downside capture** indicates how well a manager has performed in both up and down markets;
- The **information ratio** measures how consistent a manager is in generating excess return over their benchmark index; and

- The **Sharpe Ratio** measures the excess return of a portfolio above the risk-free rate, per unit of volatility or total risk, providing a risk-adjusted return for a manager.

Qualitative factors can also provide important information in evaluating, and selecting the appropriate investment manager. These include the manager's experience, consistency in following their stated investment philosophy and strategy, research capabilities, staff turnover and the ownership structure of their organization. This information can complement your quantitative analysis and assist in the selection process. Ultimately, however, the most critical consideration in your evaluation is whether or not your investment goals are being achieved.

## Goals-based investing

Investing to a set of goals – for example, buying a home, saving for retirement or planning for your child's education – ensures that your unique circumstances, timelines and objectives are considered, and drives the evaluation of your portfolio's performance. Instead of concentrating on performance relative to specific benchmarks, goals-based investing is structured around the individual investor and their priorities.

Traditionally, investors identified two or three investment goals and then put all their assets into a single portfolio in order to meet these combined objectives. Based on the investor's risk tolerance and time horizon, their portfolio was expected to generate a return with an anticipated level of risk. Most often, risk in this approach was measured against broad indices and benchmarks. Conversely, in goals-based

investing an investor matches their specific investment objectives to the appropriate investment strategy. In this case, risk is not viewed solely in relation to specific benchmarks, but in a failure to attain a stated goal.

Goals-based investing also recognizes that, as an investor, you may have many, and sometimes conflicting, goals. Instead of putting all your assets into a single portfolio with a unified strategy, a separate investment strategy is chosen for each goal. This approach provides two primary benefits.

The first is that goals-based investing addresses issues of investor bias and irrational behavior. Many investors make decisions based on emotion and short-term market fluctuations which can negatively impact their portfolio. Modern behavioral finance has identified several biases that investors are susceptible to, including:

- **Confirmation bias** occurs when investors ignore potentially useful information in favour of seeking information that confirms their existing opinions;
- **Loss aversion bias** can occur when an investor achieves greater satisfaction from avoiding losses than achieving gains;
- **Regret aversion bias** happens when investors dismiss the fact they've made a bad decision – to avoid unpleasant feelings associated with having made a poor decision – causing them to stick with their decision which can result in a worse outcome; and
- **Overconfidence** can result from an investor overestimating their own abilities or the accuracy of their predictions, causing them to underestimate risks and their ability to control events.

Concentrating on a set of goals helps mitigate against these behaviours; allowing you to refrain from panic selling in down markets or acting on the latest stock “tip,” in favour of focussing on your objectives.

Secondly, by measuring success against each goal, you always know where your investments stand relative to each of these goals. For example, an investor who is saving for a child's education will know if they are on track to having enough money to pay for their child's education based on the amount required, vis-à-vis their time horizon.

Incorporating a goals-based investment philosophy allows you to focus and align your investment success relative to your individual objectives, reduces behavioral biases and increases commitment your stated goals. While benchmarks are valuable in measuring your success and providing perspective, they should complement a goals-based strategy.



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Speak to your BMO financial professional to develop a goals-based strategy to help you meet your objectives.

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