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 your portfolio’s performance, 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 important, portfolio risk is also an important factor to consider.

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 in investment manager evaluations (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) 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, including:

1. **Upside and downside capture**, which indicates how well a manager has performed in both up and down markets;
2. **The information ratio**, which measures how consistent a manager is in generating excess return over their benchmark index per unit of volatility or total risk; and
3. **The Sharpe Ratio**, which measures the excess return of a portfolio above the risk-free rate, per unit of volatility or total risk, and provides a risk-adjusted return for an investment manager.

Qualitative factors can also provide important information when evaluating, and selecting, an investment manager. These qualitative factors include: the manager’s experience, their consistency in following their stated investment philosophy and strategy, their research capabilities, staff turnover, and the ownership structure of their organization. However, ultimately, 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 ensures that your unique circumstances, timelines and objectives are considered, and drives the evaluation of your portfolio’s performance. These goals may include buying a house, saving for retirement, or planning for your child’s education. Instead of concentrating on portfolio performance relative to specific benchmarks, goals-based investing is structured around the individual investor and their priorities.

Traditionally, investors identify two or three investment goals and then put all of their assets into a single portfolio to meet all these objectives combined. Based on the investor’s risk tolerance and time horizon, their portfolio is expected to generate a return with an anticipated level of risk. With this approach, risk is most often 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 several different goals, some of which may be conflicting. In order to address each goal individually, a separate investment strategy is chosen for each goal. This approach provides two primary benefits:

1. Issues of investor bias and irrational behavior are addressed as investors make decisions based on emotion and short-term market fluctuations, which can negatively impact their portfolio. Modern Behavioural Finance has identified several biases to which investors are susceptible, including:
   - **Confirmation bias**, which occurs when investors ignore potentially useful information in favour of seeking information that confirms their existing opinions;
   - **Loss aversion bias**, which can occur when an investor achieves greater satisfaction from avoiding losses than achieving gains;
   - **Regret aversion bias**, which happens when investors dismiss the fact they’ve made a bad decision – to avoid unpleasant feelings associated with having made a poor decision. This can cause them to stick with their decision, resulting in a worse outcome; and
   - **Overconfidence**, which can result from an investor overestimating their own abilities or the accuracy of their predictions. This can cause them to underestimate risks and their ability to control events.

Concentrating on a set of goals helps mitigate against these behavioural biases by helping you focus on your objectives and refrain from “panic selling” in down markets or acting on the latest stock “tip.”

2. By measuring success against each of your investment goals you always know where your investments stand, relatively. For example, if you are saving for your child’s education, you’ll know that you’re on the right track because you know how much you need in order to fund their education, and your time horizon to achieve your goal.

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 to your stated goals. While benchmarks are valuable in measuring your success and providing perspective, they should complement a goals-based strategy.

If you’d like to further discuss your investment strategy, please contact your BMO financial professional.