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CREATE YOUR OWN PORTFOLIO BENCHMARK

A custom benchmark tracks performance and keeps long-term investors grounded through market turmoil.

By: Rebecca Lake - September 29, 2017

Much of the heavy lifting of investing centers on choosing the right assets for your portfolio. How those investments perform can influence your short-term decision-making and long-term outcomes.

Choosing a benchmark to measure your portfolio's performance against is standard practice for many investors. For example, the Standard and Poor's 500 index is a commonly used benchmark. Some investors may measure their portfolios against a specific asset class or sector. Others may use a target-date fund based on their retirement age as a performance guideline.

Benchmarking can be useful for measuring risk and returns in a portfolio over time. The problem, however, lies in using a benchmark that doesn't account for your individual objectives, emotions or risk tolerance. "Investing can be an emotional roller-coaster ride, and many investors are more prone to irrational behavior when losing money than when making money," says Greg Oray, president and investment advisor representative at Oray King Wealth Advisors in Troy, Michigan.

By using a benchmark that doesn't reflect their preferences, investors risk making an apples-to-oranges comparison when measuring performance, encouraging even more irrational behavior, Oray says. Having a customized benchmark "paints a clearer picture of performance," which can lead to smarter investment decisions. But creating a personalized benchmark requires some self-examination.

A written plan keeps you grounded. Discipline and commitment are critical to investing. An investment policy statement (IPS) can lay the groundwork for developing a personal benchmark. This written plan for managing your portfolio is something every investor needs because it puts you and your financial advisor on the same page regarding your expectations and comfort level, says Ken Heise, a financial advisor with Heise Advisory Group in St. Louis.

An IPS becomes particularly important in retirement and in the five years or so preceding it to ensure you're not taking on an unreasonable amount of risk. This statement is invaluable for benchmarking because an IPS requires you to create a baseline for monitoring your investment performance. The more specifically an IPS defines your asset allocation, the easier it is to create an appropriate portfolio benchmark, Oray says.

The policy statement also helps keep your anxiety in check when there's market volatility. "The worry with many investors is that there will be knee-jerk reactions to market fluctuations," says Chris Cook, founder and president of Beacon Capital Management in Dayton, Ohio. "The IPS serves as a guideline for the investor – and their portfolio manager – because it lays out in specific terms goals and objectives, asset allocation, risk tolerance and any liquidity requirements the investor may have."

Without an IPS in place, you may be more prone to let day-to-day market fluctuations affect your investing decisions. That could lead you to chase performance or time the market, and both can hurt a portfolio's growth.

The best benchmark reflects your investing knowledge. There's more than one way to establish a personal benchmark. The one that fits you best depends on your investment savvy and understanding of the standard benchmarks used in the industry, Oray says.

Basing your benchmark on your asset class allocations is one option, says Anthony Mirhaydari, an analyst at InvestorPlace.com, which offers stock market news, advice and trading tips. For instance, "a 75 percent large-cap U.S. equity and 25 percent Treasury portfolio should be tracked against a 75 percent S&P 500 and 25 percent long-term Treasury model portfolio."

If you're investing with mutual funds, Mirhaydari says you should be reviewing quarterly statements to see how a fund's performance compares with appropriate benchmarks. This means you'll have to review each allocation individually to get a sense of how your investments are doing.

Inflation is another marker for gauging performance. In fact, Cook considers inflation the best benchmark because it measures the cost of goods and services people buy. "That's ultimately why we invest – to buy stuff down the road," he says, and to do that, you need to cover inflation. He recommends measuring your portfolio against an inflation rate of 2 to 6 percent, depending on how aggressively you invest. From there, you can set your performance targets a few points higher.

A benchmark also can be based on how much money you think you'll need in retirement, Heise says. This can help you figure out the rate of return you'll need your investments to generate to hit the target. And, it can help you avoid taking on too much risk.

"You should have a purpose when you invest," says Heise, who often sees his clients pursuing 8 or 9 percent returns for no reason. An income analysis may show they only need a 5 percent return to reach their goals. "There's no reason to take a downside risk that's higher than you're comfortable with if you don't need that high of a return," he says.

Monitoring portfolio performance requires moderation. Setting a benchmark doesn't mean you should be hands-off about managing your investments. You still need to monitor your progress regularly. How often you check your performance depends on your investment style, says Kei Sasaki, regional chief investment officer for Wells Fargo Private Bank in New York.

Day traders may be more likely to track performance daily against a market index or an absolute return. Strategic investors, on the other hand, are more likely to check in quarterly or semi-annually if they're taking the long view with investments.

Don't check investment performance too frequently. Doing so could lead you to veer off-course from your investment plan and make costly reactionary adjustments in the heat of the moment. "One off quarter doesn't necessarily mean you need to make drastic changes to your portfolio," Heise says.

The most important thing, Sasaki says, is to recognize if your portfolio deviates sharply from your benchmark as that "could be a signal you need to reassess the portfolio itself or whether the benchmark is still relevant." Your benchmark should evolve as you grow older, so if your portfolio strategy changes, the benchmark may need updating, too.

Greg Oray, president and investment advisor of Oray King Wealth Advisors, is dedicated to assisting individuals and their families with lasting financial guidance. Greg's background in education, coupled with his industry experience provides him with a high degree of knowledge in the financial services business.

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