Understanding the Underperformance Question

Have you ever wondered if your portfolio was underperforming and if so, why?

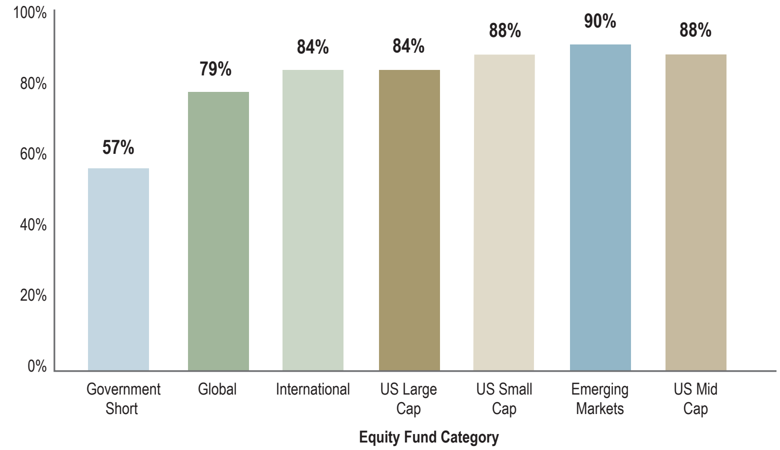
While the question is valid, it's impossible for anyone to answer it properly without first examining your overall investment approach and the benchmarks used to compare returns.

First Decision To Be Made: Active Or Passive?

If you invest using an active management investment strategy, you are hoping that the manager you've hired can accurately identify the right securities and/or when to be in the markets at the right time. Your intent is to beat the market.

As the chart below shows, historically, the majority of active managers have had a tough time outperforming their indices.

Percentage of Active Funds that Failed to Beat their Index
2005 – 2014



Source: Standard & Poor's Indices Versus Active Funds Scorecard (SPIVA), year end 2014. Index used for comparison: US Large Cap — S&P 500 Index; US Mid Cap — S&P MidCap 400 Index; US Small Cap — S&P SmallCap 600 Index; Global Funds — S&P Global 1200 Index; International — S&P 700 Index; Emerging Markets — S&P/IFCI Composite; Government Short — Barclays Capital US 1-3 Year Government Index. Outperformance is based upon equal weight fund counts. For illustrative purposes only. Index returns do not include payment of any sales charges or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. Past performance is not an indication of future results.

However, if you invest using a passive management investment strategy (think indexing or Asset Class Investing), your goal is to get the market rate of return for each asset class, rather than try to beat the market.

If you compare individual investments, like mutual funds, you must first identify the asset class of the fund and then compare it to the respective asset class return. If the mutual fund had a lower return than the asset class, then the investment underperformed.

When you wonder about investment "underperformance," first determine whether your approach intends to beat the asset class or match the asset class.

Second Decision To Be Made: What Are The Benchmarks For Comparing Returns?

Many investors mistakenly think the Dow Jones or S&P 500 is "the market." This would be true if your portfolio were made up of only U.S. Large Cap stocks! However, a diversified portfolio is built with many different types of assets, not concentrated in one. It's important to understand the difference, and why diversification is so important.

Let's take a look at the randomness of returns in the chart below:

Asset Class Index Performance 2000 – 2014

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	Annualized Returns
REITs 26.37%	Small Value 40.59%	5 Year Gov't 12.93%	Small Value 74.48%	REITs 31.58%	Emerging Markets 34.00%	REITs 35.06%	Emerging Markets 39.42%	5 Year Gov't 13.11%	Emerging Markets 78.51%	Small Value 34.59%	5 Year Gov't 9.46%	Large Value 28.03%	Small Growth 47.34%	REITs 30.14%	REITs 12.67%
5 Year Gov't 12.59%	REITs 13.93%	REITs 3.82%	Emerging Markets 55.82%	Small Value 27.33%	EAFE 13.54%	Emerging Markets 32.14%	Large Growth 15.70%	Inflation (CPI) 0.09%	Small Value 70.19%	Small Growth 31.83%	REITs 8.29%	Small Value 20.32%	Large Value 43.19%	S&P 500 Index 13.69%	Small Value 11.88%
Inflation (CPI) 3.39%	5 Year Gov't 7.62%	Inflation (CPI) 2.38%	Small Growth 54.72%	Emerging Markets 25.55%	REITs 12.16%	EAFE 26.34%	EAFE 11.17%	S&P 500 Index -37.00%	Large Growth 38.09%	REITs 27.96%	Large Growth 6.42%	Emerging Markets 18.22%	Small Value 40.29%	Large Growth 11.80%	Emerging Markets 7.05%
Small Value -3.08%	Inflation (CPI) 1.55%	Emerging Markets -6.17%	EAFE 38.59%	EAFE 20.25%	Large Value 9.70%	Large Value 21.87%	5 Year Gov't 10.05%	REITs -37.73%	Small Growth 38.09%	Large Value 20.17%	Inflation (CPI) 2.96%	REITs 18.06%	Large Growth 39.43%	Large Value 6.60%	5 Year Gov't 5.47%
Large Value -6.41%	Emerging Markets -2.62%	Small Value -11.72%	REITs 37.13%	Large Value 17.74%	Small Growth 6.02%	Small Value 21.70%	S&P 500 Index 5.49%	Large Growth -39.12%	Large Value 37.51%	Emerging Markets 18.88%	S&P 500 Index 2.11%	EAFE 17.32%	S&P 500 Index 32.39%	Small Growth 5.92%	S&P 500 Index 4.24%
S&P 500 Index -9.10%	Large Value -2.71%	EAFE -15.94%	Large Value 36.43%	Small Growth 11.16%	S&P 500 Index 4.91%	S&P 500 Index 15.79%	Small Growth 4.99%	EAFE -43.38%	EAFE 31.78%	Large Growth 17.64%	Small Growth -4.43%	Large Growth 17.22%	EAFE 22.78%	5 Year Gov't 3.12%	Small Growth 3.65%
EAFE -14.17%	Small Growth -4.13%	Large Growth -21.93%	S&P 500 Index 28.68%	S&P 500 Index 10.88%	Small Value 4.46%	Small Growth 9.26%	Inflation (CPI) 4.08%	Small Growth -43.41%	REITs 27.99%	S&P 500 Index 15.06%	Small Value -10.78%	S&P 500 Index 16.00%	REITs 2.47%	Inflation (CPI) 1.61%	Large Growth 3.17%
Large Growth -14.33%	S&P 500 Index -11.89%	S&P 500 Index -22.10%	Large Growth 17.77%	Large Growth 5.27%	Inflation (CPI) 3.42%	Large Growth 5.97%	Large Value -12.24%	Small Value -44.50%	S&P 500 Index 26.46%	EAFE 7.75%	EAFE -12.14%	Small Growth 12.59%	Inflation (CPI) 1.51%	Small Value 1.44%	EAFE 2.54%
Small Growth -24.50%	Large Growth -21.05%	Large Value -30.28%	5 Year Gov't 2.40%	Inflation (CPI) 3.26%	Large Growth 3.39%	5 Year Gov't 3.14%	REITs -15.69%	Large Value -53.14%	Inflation (CPI) 2.72%	5 Year Gov't 7.12%	Emerging Markets -18.42%	5 Year Gov't 2.07%	5 Year Gov't -1.07%	Emerging Markets -2.19%	Large Value 2.51%
Emerging Markets -30.83%	EAFE -21.44%	Small Growth -34.63%	Inflation (CPI) 1.88%	5 Year Gov't 2.25%	5 Year Gov't 1.36%	Inflation (CPI) 2.54%	Small Value -18.38%	Emerging Markets -53.33%	5 Year Gov't -2.40%	Inflation (CPI) 1.50%	Large Value -19.90%	Inflation (CPI) 1.74%	Emerging Markets -2.60%	EAFE -4.90%	Inflation (CPI) 2.30%

**Data Sources: Center for Research in Security Prices (CRSP), BARRA Inc. and Morgan Stanley Capital International, March 2015. All investments involve risk. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes, and different methods of accounting and financial reporting. Past performance is not indicative of future performance. Treasury bills are guaranteed as to repayment of principal and interest by the U.S. government. This information does not constitute a solicitation for sale of any securities. CRSP ranks all NYSE companies by market capitalization and divides them into 10 equally-populated portfolios. AMEX and NASDAQ National Market stocks are then placed into deciles according to their respective capitalizations, determined by the NYSE breakpoints. CRSP Portfolios 1-5 represent large-cap stocks; Portfolios 6-10 represent small caps; Value is represented by companies with a book-to-market ratio in the top 30% of all companies. Growth is represented by companies with a book-to-market ratio in the bottom 30% of all companies. S&P 500 Index is the Standard & Poor's 500 Index. The S&P 500 Index measures the performance of large-capitalization U.S. stocks. The S&P 500 is an unmanaged market value-weighted index of 500 stocks that are traded on the NYSE, AMEX and NASDAQ. The weightings make each company's influence on the index performance directly proportional to that company's market value. The MSCI EAFE Index (Morgan Stanley Capital International Europe, Australasia, Far East Index) is comprised of over 1,000 companies representing the stock markets of Europe, Australia, New Zealand and the Far East, and is an unmanaged index. EAFE represents non-U.S. large stocks. Foreign securities involve additional risks, including foreign currency changes, political risks, foreign taxes and different methods of accounting and financial reporting. Consumer Price Index (CPI) is a measure of inflation. REITs, represented by the NAREIT Equity REIT Index, is an unmanaged market cap-weighted index comprised of 151 equity REITS. Emerging Markets index represents securities in countries with developing economies and provide potentially high returns. Many Latin American, Eastern European and Asian countries are considered emerging markets. Indexes are unmanaged baskets of securities without the fees and expenses associated with mutual funds and other investments. Investors cannot directly invest in an index.*

As the chart shows, every year there is a different winner and a different loser — and the asset classes in between behave just as randomly. When you employ a diversified strategy you strive for less volatility by owning a broad variety of asset classes.

Since one of the goals of diversification is to avoid the highs and lows that accompany investing in one asset class, it is statistically impossible for a diversified portfolio to ever outperform the top asset class for any given year. On the flip side, a diversified portfolio will always outperform the worst asset class in the portfolio.

Some investors may suggest excluding the worst performing asset classes from the portfolio. But as the chart shows again and again, the performance of each asset class from year to year is random. Today's bottom performer can easily be tomorrow's top asset class — and vice versa.

It may be better to own a broad variety of asset classes, allocated according to your risk tolerance and time horizon, and put your trust in capitalism's long-term potential to create wealth (regardless of which country that may come from).

In summary, the next time you are concerned about possible portfolio underperformance, think about the two decisions: Was the strategy behind your portfolio intended to beat or match an asset class and are you using the proper benchmark for comparison?

Diversification cannot guarantee a profit or protect against a loss.