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BENCHMARKS: THE FRAMEWORK FOR INVESTMENT EVALUATION

Executive Summary

- A benchmark is a relevant standard used to evaluate investment performance.
- It provides a reference point against which investment performance can be properly assessed and serves as the standard that contextualizes returns, enabling investors to determine whether their portfolios are truly outperforming or underperforming based on their specific investment objectives and risk profiles.
- A benchmark must be specified in advance, appropriate, measurable, unambiguous, reflective of current investment opinions, accountable (or accepted), and investable.[1]



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In the world of investment management, accurately measuring performance of a portfolio is essential for investors to understand if their financial strategies are working effectively. Yet, raw returns alone provide an incomplete picture of how one's portfolio may be doing in comparison to another. Without proper context, investors may draw faulty conclusions. For example, mistaking a 3% return on a conservative emergency fund and viewing it as underperforming compared to a 9% return on an aggressively invested managed account. Similarly, another investor might compare their 60/40[2] managed portfolio to the S&P 500 and feel disappointed that it hasn't kept pace. This fundamental misunderstanding highlights why benchmarks serve as the cornerstone of meaningful performance evaluation.

A benchmark provides a reference point against which investment performance can be assessed. It serves as the standard that contextualizes returns, enabling investors to determine whether their portfolios are outperforming or underperforming based on their specific investment objectives and risk profiles. In this paper, the TIAA Wealth Chief Investment Office (Wealth CIO) explores the critical role benchmarks play in performance measurement, examining how properly constructed benchmarks provide the foundation for sound investment decision-making.

What is a benchmark?

A benchmark is defined as an appropriate standard against which to measure investment performance. Its primary purpose is to provide context for evaluating how an investment portfolio is performing.

For clients in TIAA Wealth Management's managed accounts, the benchmark acts as a starting point for how investments are spread across different types of assets—such as large cap stocks, small cap stocks, and international bonds. Each strategy

[1] The qualities of a valid benchmark as per the CFA institute.

[2] A portfolio comprised of 60% equity and 40% fixed income.

has its own benchmark that matches a specific level of risk and remains neutral, meaning it doesn't change based on short-term market opinions. These benchmarks provide a comparison in a way that's clear and aligned with each investor's goals. Consider the example below:

FIGURE 1

Benchmark composition should be aligned with the investment strategy and the portfolio's risk tolerance to ensure consistency and relevance.

Investment objective	Investor risk tolerance	Benchmark composition example
Conservative	Low	70% Bonds, 21% U.S. Equity, 9% International Equity
Moderate	Medium	40% Bonds, 42% U.S. Equity, 18% International Equity
Aggressive	High	13% Bonds, 61% U.S. Equity, 26% International Equity

Source: TIAA Wealth Management Chief Investment Office.

Each benchmark is tailored to match the strategy's risk profile while maintaining global diversification. For example, the Moderate strategy aims to balance growth and stability by combining U.S. and international stocks with about 40% of the portfolio in bonds. If an investor prefers less risk, the portfolio would typically allocate more to bonds and less to stocks. On the other hand, a higher-risk strategy—such as Aggressive—would lean more heavily toward stocks than bonds. It's essential to make sure each strategy is compared to a benchmark that closely matches its risk level and investment approach. If a strategy is measured against a benchmark that doesn't match its level of risk or mix of investments, the results can be misleading and can cause confusion about how well the strategy is performing.

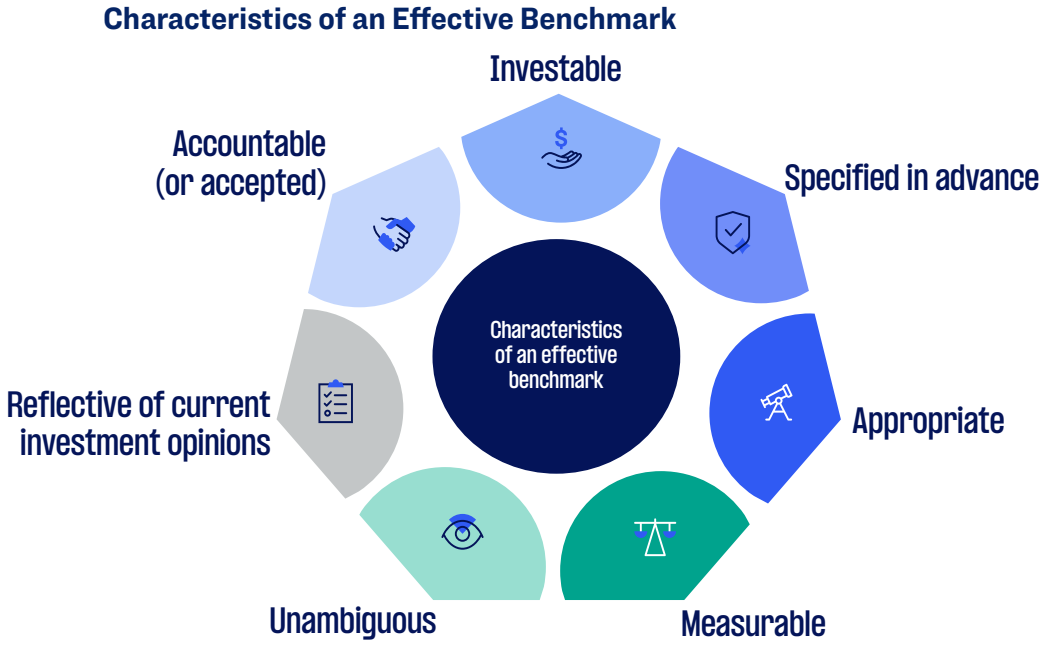
Proper performance evaluation is based on excess return, which is the difference between the portfolio return and performance of an appropriate benchmark. Excess return is positive when the investment return exceeds the benchmark return, and negative when it falls short. However, performance should not be assessed in isolation as one must consider risk. A portfolio that outperforms its benchmark may still be suboptimal if it does so by taking on significantly more risk. Therefore, a comprehensive evaluation considers both excess return and the level of risk taken to achieve that return, while aligning it with the investor's objectives and risk tolerance.[3] For more on performance evaluation, refer to the Investment Essentials: Understanding Portfolio Performance.

While benchmarks are useful tools for evaluating investment performance, they shouldn't be portrayed as the only or ultimate measure of success. Investors may have personal financial goals—such as saving for retirement, funding education, or preserving capital—that are not always reflected in benchmark comparisons. Therefore, it's important to recognize that achieving personal financial goals is more meaningful than simply outperforming a benchmark.

[3] Risk tolerance is typically assessed through a combination of structured tools and personalized advisory engagement designed to gauge a client's comfort level with market voltility, potential losses, and investment time horizon.

FIGURE 2

The characteristics of an effective benchmark.



Source: Chartered Financial Analyst (CFA) Institute, TIAA Wealth Chief Investment Office.

A benchmark should possess all specific qualities that make it suitable for performance measurement and evaluation of investment managers (Figure 2). According to the Chartered Financial Analyst (CFA) Institute, an effective benchmark must be :

1. **Specified in advance:** A benchmark must be clearly defined and constructed prior to the start of the evaluation period to ensure objectivity and transparency. For example, if performance tracking for the portfolio is set to start on January 1, 2026, the portfolio manager needs to choose a benchmark before this period begins.
2. **Appropriate:** It must align with the investor's specific style, mandate, or area of expertise. For example, the S&P 500 would be an appropriate benchmark for a portfolio of large cap U.S. stocks, but not for one focused on international small cap stocks.
3. **Measurable:** The benchmark's performance must be readily calculable and available on a reasonably frequent and timely basis, such as daily, monthly, or quarterly. This is necessary for accurate and consistent performance measurement.
4. **Unambiguous:** The benchmark should clearly list which investments it includes and what percentage it accounts for. It should follow simple, consistent rules for choosing, weighting, and updating those investments without frequent changes or personal judgment. For instance, a benchmark made up of 60% S&P 500 Index and 40% Bloomberg U.S. Aggregate Bond Index clearly spells out what's included and the exact share of each.
5. **Reflective of current investment opinions:** The manager has current investment knowledge of the securities or factor exposures within the benchmark, whether it is positive, negative, or neutral. For example, if an investment manager is running a large-cap equity strategy and agrees to use the S&P 500 Index as the benchmark, it demonstrates that the manager is actively engaged with and has informed views on the securities within that index.
6. **Accountable (or accepted):** The investment manager must be aware of and accept the benchmark as an appropriate standard against which their performance will be evaluated. For example, if an investment manager is running a large-cap equity strategy and agrees to use the S&P 500 Index as the benchmark, it shows they accept it as the standard for evaluating results.
7. **Investable:** The benchmark should include assets that clients could realistically buy, allowing them to match the benchmark without paying high transaction costs. A portfolio made up of easily accessible ETFs that track well-known indexes like the S&P 500 or U.S. Aggregate Bond Index offers a practical and cost-effective way to replicate the benchmark.

Types of Benchmarks

Benchmarks play a crucial role in investment evaluation, and they generally fall into two categories: benchmark indexes and blended benchmarks.

- **Benchmark indexes:** Act as proxies for specific asset classes, helping investors evaluate performance and allocate assets effectively. For example, the S&P 500 serves as a benchmark for U.S. large-cap equities, the Bloomberg Aggregate Bond Index represents U.S. fixed income, and the FTSE 3-Month Treasury Bill Index is commonly used for cash equivalents.

- **Blended Benchmarks:** Used for diversified investment strategies and consist of a mix of multiple indexes.

In this example, assume an investor has three different accounts:

1. A retirement account invested in an aggressive allocation (13% Bonds, 61% U.S. Equity, 26% International Equity, as shown in Figure 1).
2. A managed account that is invested in a moderate allocation (40% Bonds, 42% U.S. Equity, 18% International Equity, also shown in Figure 1).
3. A cash savings account invested in cash equivalents.

As shown in Figure 3, each investment account may yield different performance outcomes due to variations in investment objectives, which are shaped by factors such as strategy, risk tolerance, and time horizon.

FIGURE 3

Example of investment accounts consisting of multiple strategies.

Account	Investment objective	Portfolio return
Retirement	Aggressive	8.0%
Managed Taxable	Moderate	6.0%
Cash / Savings	Cash Equivalents	3.0%

Source: TIAA Wealth Management Chief Investment Office. Examples included are hypothetical and for illustrative purposes only.

The key question is not *how much* an account earns—but *how well* it performs relative to its intended purpose. Returning to our example, suppose that appropriate benchmarks are created for each investment objective with returns as shown in the above table.

By incorporating a benchmark and evaluating excess return, investors can more effectively assess performance as shown below in Figure 4.

FIGURE 4

Evaluating excess return within the context of a benchmark provides a clearer measure of performance.

Account	Investment objective	Portfolio return	Benchmark return	Excess return
Retirement	Aggressive	8.0%	8.5%	-0.5%
Managed Taxable	Moderate	6.0%	5.0%	1.0%
Cash / Savings	Cash Equivalents	3.0%	3.0%	0.0%

Source: TIAA Wealth Management Chief Investment Office. Examples included are hypothetical and for illustrative purposes only.

Disclaimer: While it is impossible to invest directly in a benchmark, proxy investments such as Exchange-traded funds (ETFs) that closely track specific indexes are available for investment. However, like all ETFs, there are varying expense ratios associated with investing in these assets. The Benchmark Indexes and Blended Benchmarks described above are hypothetical only and not necessarily used by the TIAA Wealth CIO.

By managing to an appropriate benchmark, there is an applicable standard from which to measure investment performance. In this example, the Retirement account, invested aggressively, underperformed by -0.5%; the Cash/savings account had no excess return; and the Managed taxable account, invested with moderate risk, outperformed by 1.0%. Now, we have a more reliable approach in benchmarking to understand performance. By aligning each account's outcome with its benchmark, we shift from simply observing returns to meaningfully evaluating performance.

Conclusion

In summary, benchmarks provide the critical context needed to evaluate investment performance meaningfully, allowing comparisons that align with the specific investment objectives and risk profiles of different accounts. TIAA's Wealth CIO utilizes benchmarking not only as a performance measurement tool but also as a strategic framework to align investment decisions with investor goals. By choosing benchmarks that match each portfolio's goals and risk level, the Wealth CIO team allows for performance to be measured fairly and accurately.

CIO INVESTMENT ESSENTIALS

TIAA Wealth Management

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