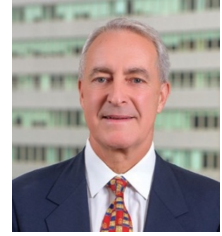

Thoughts for Investors

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The Pitfalls of Comparison - The Only Benchmark is Your Own

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"To compare is not to prove."

– French Proverb

In a past newsletter, I suggested that before you invest, ask "What do I want?" and "What do I need?" The purpose is to identify your goals. As I have previously stated, X% return is not a goal, X dollars/month is a goal. You cannot spend a %. Furthermore, by focusing on a dollar goal, an investor tends to only take the risk necessary to achieve that goal. It takes a long time to make money, but a very short time to lose it.

I followed that with a newsletter suggesting you next concentrate on "perfecting your investment process" rather than concentrating on the outcome. Your investment process is what keeps you on track rather than succumbing to emotion when you invest. The purpose of having/perfecting your investment process is to make sure you didn't blame a good investment process for an unlucky outcome, or worse, attribute a good (but purely lucky) outcome to what is really a bad investment process. Once you know what you want (or need), recognizing that it constantly evolves, and you have a process for getting there, you are then ready to examine the issue of performance.

It is tempting to dismiss the need to discuss performance: the higher the performance the better, right? Every investor has the right to ask (and receive) the answer to – "How am I doing?" Unfortunately, it is a difficult question to answer because most investors do not have specific goals.

Without goals, how can an investor gauge how they are doing? As a result, many investors become impatient and emotional and quickly ask a follow-up question. It is this second question that ultimately leads to the downfall of many an investor. The question is: "How am I doing compared to _____ fill in the blank – my friend, "the stock market," or last year.

In this newsletter, I will show that an investor's success increases dramatically if they do not ask the second question at all and if they change the first question to "Am I moving toward my goal(s)?"

It is natural to compare. You are happy with your house until you see someone who has a nicer one (or has two of them). Or you could compare your job, your car, your school, or even your body shape at the gym! The list is endless. Yet there is a fine line between "striving to do better" and the "comparison trap." When investing, "striving to do better" is predicated on identifying specific goals and then moving closer to achieving them. The "comparison trap" is a state in which an investor has no specific goals and therefore cannot tell if they are succeeding or failing, and consequently they spend all their time worrying if they are "missing out" on something. There is no end to the stimulation that the media or financial intermediaries can provide on this topic. And there seems to be no end to the number of investors that succumb to the feeling of missing out by panicking, abandoning their process, and then "chasing returns." Even investors that have completed step one of identifying their specific goals will sometimes put them aside to "chase returns."

Investors insist that they need some overall measure of the performance of "the stock market" (or bond market) to "compare to." Thus, the concept of a "benchmark" or

"index" was invented. An early stock index was the Dow Jones Industrial Average. Once everyone realized that it only consisted of 30 stocks, they deemed it not representative of the "stock market" in general. Thus the S&P 500 index was created, followed by the Russell 1000 index, the Russell 2000 index, and the Wilshire 5000 index.

The theory is that with the help of a benchmark to compare to you can tell if your investments are good or bad (or maybe even whether you are happy or sad). Investments are deemed good if they outperform a benchmark and bad if they do not. Note that no benchmarks tell you if you are meeting your goals (or even moving in the right direction). When clients call and ask how the stock market is doing, I often comment that I do not care how the stock market is doing; I only care about how their accounts, and the stocks they own, are doing.

The invention of indices for use as benchmarks was followed by the invention of (and the cost of) "consultants." These are individuals who claim to help investors by telling them which indices to use for comparison. Unfortunately, the whole consulting process has only added to investor confusion. Today an investor can compare their portfolio to benchmarks of Small Cap Growth, Large Cap Value, Mid Cap Growth, Blend, Sector, Income, Growth and Income, Emerging Markets, High Yield, International, and on and on. It is debatable as to whether or not these categories can even be accurately defined. Is Microsoft large cap growth or large cap value? If more than half of a U.S. company's revenues come from overseas, is it an international stock? Another problem with using indices as benchmarks for measuring success is the "moving target" nature of indices.

Stocks are occasionally added or subtracted from the various indices in a process known only to those that create the index. Trying to outperform an index that continually changes is similar to trying to navigate from point A to point B if the North Pole is moving around. A third problem with benchmarks is the "speedometer" problem. Just because the speedometer goes up to 150 mph does not mean you should drive that fast. The same logic applies to your investments. If you are moving comfortably and timely toward your investment goals, it does not matter how fast the indices are going. Investors should not try to "chase" the performance of an index. In the end, how valuable are a consultant's services and benchmark comparisons if investment categories cannot be accurately defined, the indices are moving targets, and the whole effort causes investor to "chase" performance and usually crash and burn?

While many investors today will claim they have learned their lesson, I do not believe it. One needs to look no further than how much money poured into hedge funds when they claimed they were "beating the benchmarks"; or how much money has poured into real estate (for purely investment purposes); or last but not least how much money is now pouring into commodities like oil after it has already climbed from $10 to $73 a barrel.

"Compare your griefs to other men's and they will seem less."

– Spanish Proverb

In summary, investors with goals should measure performance by whether they are meeting or moving toward those goals. Indices are not goals and should not be used as benchmarks for determining success. By avoiding a comparison of one's performance to some ill-defined index, or the stock market in general, investors are less likely to feel they are missing out. Hence, they are also less likely to "chase returns" and will learn to only take the risk necessary to achieve their objectives. In the end, this will lead to less comparison anxiety and the true performance success they are striving toward.

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Hear the Other Side

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