Topic 3: Do I have to benchmark my Investment Performance?

In 2017 it is easy for a trustee of a Self-Managed Super Fund (SMSF) to meet their compliance obligation to review their investment strategy. Basically just tick a box. Done.

SMSF trustees are not required to benchmark their total fund performance, and as a result many trustees have no idea what their return was over a period, whether their return was any good, or whether they could have achieved a better outcome by including something else in the mix.

Professor Ron Bird from the University of Technology, Sydney, has presented research into this issue in September 2017, which he calls the “information-gap”.

Why Benchmark?

If you don’t have to benchmark your investment performance, why would you?

Benchmarking is a management tool used by many successful sporting organisations, businesses and government departments… to improve performance.

An early adopter of benchmarking was photocopier giant XEROX. They had a dominant position in their market, but were only benchmarking internally. “How are we going against the goals we set for ourselves?”, and the answer was “good”.

But when they decided to benchmark externally, “How are we going compared to others in our industry” they learned that they had fallen way behind. In fact, they were in danger of going out of business. They claim that external benchmarking helped save their business and adopt some new practices which saw them continue to thrive, by learning from others.

It is similar for investing. Whatever you want to invest in, there are different ways to do it.

For example if you want some Australian shares in your portfolio you could:

- Buy them directly and hold without trading,
- Buy directly and regularly trade
- Access them through an active fund manager
- Access them through an Index fund, an Exchange Traded Fund, a Separately Managed Account and so on.

Once you decide which approach you think is going to work best for you, there is no need to be ‘wedded’ to that approach.

It makes sense to regularly check how your current approach is going, not just against your own internal goals, but externally as well, and decide whether you want to maintain that approach, modify it a bit, or perhaps include something else in the mix that may lead to better outcomes over time.

Benchmarking as part of an organised process should help you lift your SMSF performance over time, because it gives you affirmation that all is well, or perhaps an early warning that some action could be taken to keep on track.

Why are some SMSF trustees reluctant to benchmark their fund performance?

1. **Lack of engagement**

Firstly, there are some SMSF trustees who are not very engaged with their funds despite the fact that they have a lot of money tied up in their fund, and their future lifestyle, or ability to self-fund their retirement, depends on it.

Similarly to students, SMSF trustees who are not engaged and likely to under-perform.

2. **“The Ostrich Effect”**

Some SMSF trustees feel ‘emotionally invested’ in their chosen investment approach. They see it as a reflection of themselves. If their portfolio has under-performed, they would rather ‘bury their heads in the sand’ than acknowledge this and look to understand what has happened, why it has happened, what is likely to happen from here, and what is the best course of action.

Let’s change the focus. With benchmarking, the investor is not under the spotlight. The investor is shining the spotlight on their current investment approach. How is it going? If they discover that it is in fact under-performing then they have learned something valuable, and they can consider what action they want to take, if any.

3. **“I’m Only Interested In Income”**

Some SMSF Trustees in retirement say that they are no longer interested in their fund performance, they are only interested in the amount of dividends they receive.

There are some risks with this approach, and it may result in them having a reduced income in later years.

Dividend Risk

Traditionally, dividends paid by a business would be no more than half their profit. But to satisfy the demands of investors chasing yield, many businesses have adopted an unhealthy practice of distributing a high proportion of earnings as dividends, leaving very little for future growth, or to protect the business in the long term.

Indeed some businesses are distributing more than 100% of their profit as dividends, by borrowing money. This is unsustainable, and there is a risk that some businesses will fail, or fail to grow their dividends to keep up with inflation, or fail to pay any dividends at all for a period of time.

Diversifying some of an SMSF portfolio away from “High-Yield stocks” may help to manage risk and yield better outcomes over time.

Income Vs Total Return

Investors should consider their total return, and not just their dividends, even if they are older Australians in retirement, because of the basic maths.

Net Earnings(E) = Income Distributed (I) + Growth (G)

This applies to any investment, where shares, property or fixed interest.

A share investor who is only interested in dividends is failing to see that the more important factor is the underlying earnings of the business. After all, if some of the earnings are re-invested in the business which results in a higher share price, you can still access this money, by selling some of the shares.

Let’s look at some real examples of the total returns of various asset classes, to demonstrate the point.[1]

Asset Class	**3 year return to 31/8/17**
Australian Financials	3.67%
US Shares	15.48%
Asia ex Japan	14.86%
International Small	15.38%
Global Healthcare	13.04%

The dividends from all sectors other than Australian Financials in the above table would have been low. However, it is easy to cash in the growth each year, and investors would have been a long way better off to have included some of the other sectors in the mix.

Note: This should not be taken as a recommendation to invest in these asset classes. The point is to illustrate the potential of missing out on better outcomes if an investor is only looking at the income component of their total return.

Benchmarking is only relevant because there are many different investment strategies which could be adopted by an SMSF trustee.

[1] SMSF Benchmarks publishes the returns of various asset classes using the average return of a basket of Exchange Traded Funds in each asset class. This is based on published ETF returns, before tax and after fees.