My benchmark is up 9.3% so far this year, but I'm not. Should I care?

Absolutely you should care. You can't measure performance without a yardstick. Just don't care too much. Recognize that your benchmark is imperfect, so it's more important to understand what is driving your relative performance, not so much it's magnitude.

For my growth-oriented investors, I use the Vanguard Lifestyle Growth Fund as my benchmark which as of June 30th was up 12.5% year-to-date. It's an actual fund that my clients can invest in themselves at minimum cost. If they fired me and put the proceeds this fund, they could do a lot worse. In fact, most would have done much better, at least year-to-date.

So why don't my clients fire me, especially as I don't pretend to add pre-tax "alpha", that fancy Greek letter used to measure "excess risk-adjusted return" relative to the "passive" "market"? And what's with all the quotation marks?

Therein lies my answer. In reverse order:

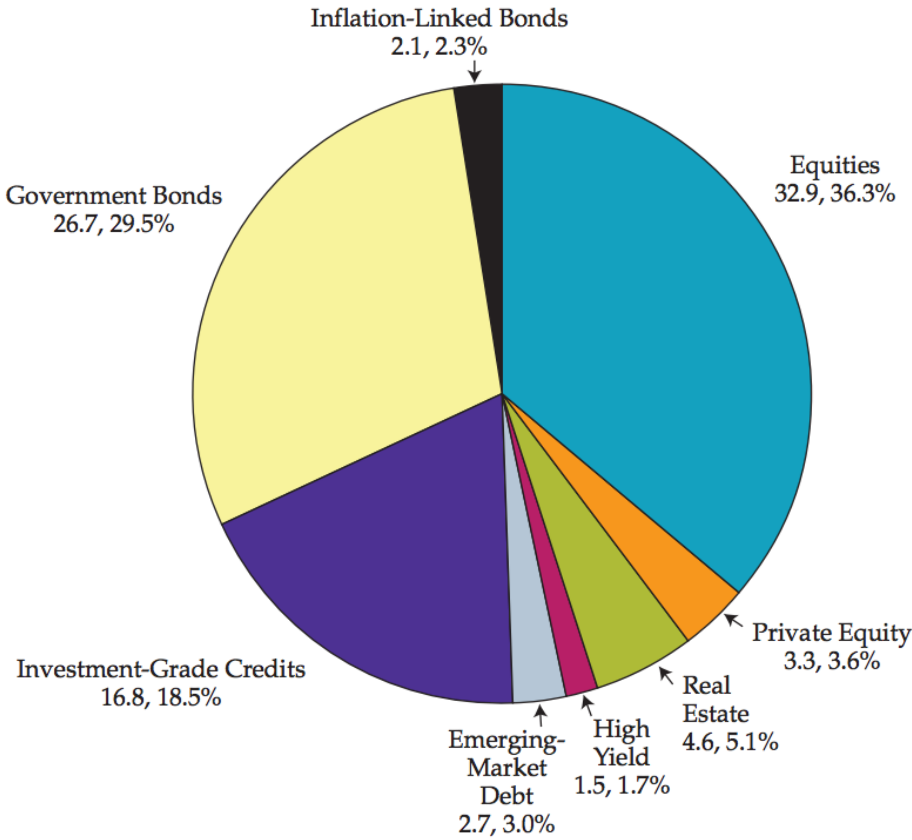
The "market" only exists in theory, not in practice. As such, "passive" investing is a myth. Given that fact, there is no way to accurately measure "alpha". Do I expect to outperform my benchmark over longer periods of time without taking on more risk? Absolutely, especially after taxes…but not because I'm smarter than "the market". What?!?! Let rest of this letter explains all of this in more detail.

What is "the market"?

In a make-believe world of market efficiency, no taxes or transaction costs, and rational investors who care about minimizing volatility while maximizing returns, the average investor should simply own "the market"[1]. Academics define this as the collective investments off all investors or in other words, every global investable asset. And this is, in fact, what the average investor does own. This global market looks like (at least as calculated by these academic folks) this:

[1] From a theoretical point of view, diverging from the true market can still be consistent for a world where investors are trying to minimize volatility and maximize returns, but also trying to hedge versus risks tied to their expected consumption. Robert Merton introduced these concepts in Merton, Robert C., 1973, An Intertemporal Capital Asset Pricing Model, *Econometrica* 41,867-887. Gene Fama and Ken French expand on them in Fama, Eugene F., and Kenneth R. French, 1996, Multifactor Explanations of Asset Pricing Anomalies, *Journal of Finance* Vol. LI, No. 1, 55-84

Figure 1. Estimated Market Values (US$ trillions) and Weights in the Global Market Portfolio at the End of 2012



If you peel back the onion of this portfolio, over 50% of the equity portion of the index is overseas and many of the government bonds have negative yields! No thanks.

Luckily, Vanguard, as they so often do, can get you a long way there, and cheaply. See the breakdown of their Vanguard Lifestyle Conservative Growth Fund below:

Equity	2	40.03
Domestic Equity Fund	1	23.99
Broad Equity	1	23.99
VANGUARD TOT STK MKT-INV		23.99
Intl Equity Fund	1	16.04
Broad Equity	1	16.04
VANGUARD TOT INT ST IDX-INV		16.04
Fixed Income	2	59.96
Core FI	2	59.96
Domestic Core	1	42.09
VANGUARD TOT BND MKT II-INV		42.09
International Core	1	17.87
VANGUARD TOTAL INTL BND-INV		17.87

It is certainly cleaner, but it is no longer “the market.” Nor is the S&P 500 and certainly not the Dow Jones Industrial Average.

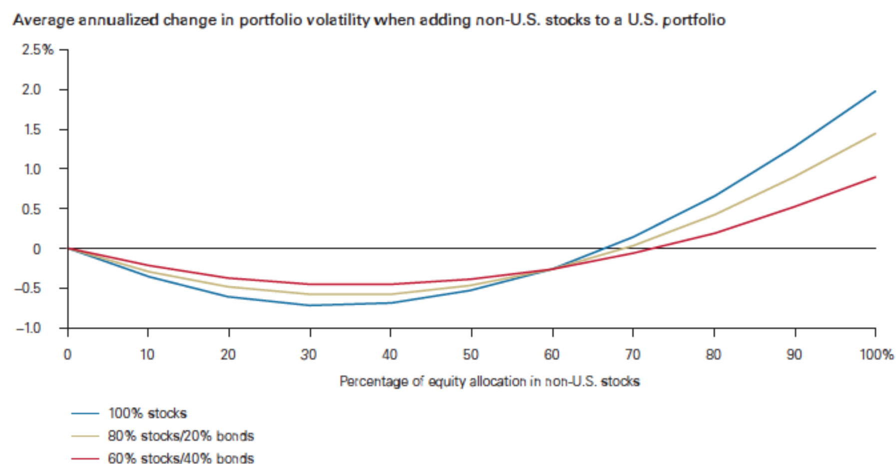
Are we being "Passive"?

The short answer is no. Even by choosing Vanguard's definition of "the market", we are taking the first of many steps away from being passive. We have actively chosen to outsource the makeup of our benchmark. Is our choice reasonable? Judging from another recent academic paper, the answer is yes. A simple global mix of 50% equities and 50% government bonds returned on average of 4.65% annually since 1960, mildly better than their more inclusive global market portfolio, and with lower volatility.

When we then decide to accept a higher degree of volatility (i.e., risk) for a higher expected return by increasing our allocation to equity, we take out second big step away from being passive. But we've only just begun.

Vanguard takes our third step away from being passive by allocating only 40% of the equity portion of the fund overseas vs the market's 52% allocation (as measured by the MSCI index). How reasonable is that? Again, it's impossible to know for sure, but using historical returns as a guide, it is reasonable, but it's not passive.

Figure 3. Adding non-U.S. stocks has historically reduced the total volatility of a portfolio



Notes: U.S. equities represented by MSCI USA Index; non-U.S. equities represented by MSCI World Index ex USA from 1970 through 1987 and MSCI All Country World Index ex USA thereafter. Bond data represented by Salomon High Grade Index from 1970 through 1972, Lehman Long-Term AA Corporate Index from 1973 through 1975, and Barclays U.S. Aggregate Bond Index thereafter. Data through December 31, 2013.

Sources: Vanguard, Thomson Reuters Datastream, and MSCI.

At this point, we start to diverge away from our benchmark and thus become even less passive. As the graph above shows, if Vanguard's 40% allocation to international is reasonable, so is 20%...closer to our choice mainly because it lessons our exposer to currency risk (see this paper by AQR).

We also believe in the merits of value investing, believing, based reams of empirical evidence, our 25+ years working in the capital markets, and common sense, that you get paid to take risk which others are looking to avoid. Or as Warren Buffett likes to say, we are greedy when others are fearful. This thinking applies across asset classes and within both equity and fixed income.

Are we providing "Alpha"?

Maybe. As unsatisfying as that answer is, it's true. We can't determine whether we are adding risk adjusted returns to the market if we can't measure the market. We can and should measure how we do versus Vanguard's best version of the market with 40% equities, and by that yardstick, our growth investors outperformed so far this year. But those investors only outperformed the Vanguard market proxy because we took more risk in the form of 80% exposure to equities. Versus the growth benchmark with a similar amount of equity exposure, we underperformed.

Why? Well, international stocks did better than domestic stocks so far this year as the dollar declined in value, China's growth resumed and European politics stabilized (as measured by Vanguard's ETFs VSUS and VTI, 15% vs 9%). In addition, value stocks underperformed growth stocks (as measured by Vanguard's ETFs xxx and xxxx, xx% vs xx%) as growth stocks like Facebook and Netflix continued to soar. And for the trifecta, interest rates went back down as inflation fears dissipated further. We felt, and still feel, the market is underestimating the risk of inflation, so didn't fully participate in the ensuring rally in bonds. Given these active decisions away from our benchmark, of course we underperformed.

Should we be concerned? Relative to Vanguard, our underweight to international stocks, overweight in value stocks, and lower exposure to interest rate increases are all based on thoughtful, theoretical reasoning, common sense, and empirical support, not on my hopes to outsmart the market. Those rationales haven't changed. And I still don't pretend to know the future direction of the dollar, interest rates or stocks like Facebook, we may just as likely underperform in the next 6 months. Over an extended period, though, our strategy to limit currency volatility and maintain a value bias should pay off. Lucky for me, for those accounts with more than a 12-month history with me have done outperformed.

But should I promote my ability to outperformance my benchmark as creating "alpha"? Alpha, as a reminder, is a measurement of excess *risk adjusted* returns. Bloomberg's sophisticated allocation analyzer says we generated alpha for our clients. But we also took risks in terms of fixed income credit, closed-end fund liquidity and smaller company equities that they even didn't try to measure. It worked out great but wouldn't have if China actually did implode or oil stayed at $20 a barrel. I wasn't and still wont have the hubris to pretend to know exactly the direction of oil or the economic future of China, but I did know I was being paid a lot to take on that risk. Now we are not, and I am reducing my risk.

Conclusion: Just because I don't know doesn't mean I don't get it.

Our inability to construct a true market portfolio, invest passively, and properly measure how we're doing in terms of alpha is frustrating. But those realizations are also liberating. We can now, and do, focus our attention on areas which we know we can control. Are we properly diversified, considering not only our 401Ks and legacy assets as well as the unique risks associated with our jobs? Are we placing our least tax efficient assets in our tax-deferred IRA's

and recognizing capital losses to optimize our tax efficiency? And lastly, are we paying too much in mutual fund fees and are you paying too much to your advisor?

Low fees, optimal tax efficiency and customized diversification are the three pillars from which we built our firm. This is how we know we create value for our clients and allow them to take full advantage of a value-centric portfolio. It's a commonsense approach to investing rooted in academic theory and empirically robust. And although we believe we will outperform our benchmark after taxes and after fees, don't judge us based on 6 months of returns or even 6 years of returns. And most of all, don't give us credit for generating alpha. Judge us based on our approach.

If you'd like read more about the fallacy of passive investing, read our recent article published on Alpha Architects' blog here. To explore our approach in more detail, visit our site website.