

# Invest smarter – escape the benchmark trap



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IN THE world of professional investing, a scary obsession has taken hold – the fixation on benchmarks and relative performance. This phenomenon, which I coin “benchmarkism”, is distorting incentives and pulling many institutional investors in the wrong direction. It is time to explore how we can escape this benchmark trap for smarter investing, where the focus is on stable long-term wealth growth.

Investment benchmarks started in the late 19th century when Charles Dow introduced the Dow Jones Industrial Average in 1896. At that time, the role of benchmarks was minimal. Investors were primarily focused on dividends, as demonstrated by funds such as those offered by international asset manager Robeco. Benchmarks played no role in Robeco’s funds until decades after the firm was founded in 1929.

It was not until the efficient market hypothesis gained prominence in the 1960s that benchmarks started becoming the investment industry’s central performance yardstick. Today, beating benchmarks is often seen as the definitive measure of success, overshadowing the most fundamental rules of investing – do not lose capital and achieve an adequate return. Investors are increasingly fixated on relative short-term performance.

## Core problem of benchmarkism

The crux of the problem with benchmarkism is that it shifts the investor’s focus away from absolute returns and capital preserva-

tion, towards outperforming the benchmark. But this can result in irrational decision making. Imagine a portfolio manager choosing between a stable stock offering an 8 per cent return and an index fund that averages 8 per cent but fluctuates wildly.

Logically, most investors would pick the stable stock for its lower absolute risk. Yet, a manager aiming to beat the benchmark might avoid the stable stock because it offers periods of no outperformance, which is a substantial risk in the realm of benchmarkism.

This behaviour reflects how the drive to beat benchmarks can push investors to take on additional risks, diverting attention away from the two fundamental investment principles of capital preservation and long-term wealth growth. In bond markets, for example, debt-laden countries or corporations often get larger weighting in bond indices. As a result, portfolios are often tilted towards the riskiest issuers, simply because they carry more debt.

That is the paradox of benchmark investing – it encourages risk taking in pursuit of relative gains, sometimes at the expense of common sense.

## Historical lesson of Fisher Black

The focus on relative return over risk management is not new. Fisher Black – one of the architects of the now 60-year-old capital asset pricing model – tried to launch a low-risk equity fund at Wells Fargo in the early 1970s.

His research demonstrated that low-beta stocks could achieve market-like returns with reduced capital risk. The fund aimed to profit from this principle of “winning by losing less”.

But it did not take off. Black’s innovative strategy faced leverage constraints, and investors were more focused on beating the market than reducing risk.

Ironically, it was not until the



An emphasis on relative performance makes defensive strategies less appealing against an increasingly concentrated benchmark, as seen in the ongoing US tech rally. PHOTO: AFP

dot-com bubble burst in 2000 and the financial crisis of 2008 that defensive, low-volatility strategies gained real traction. Several low-volatility exchange traded funds became very popular, attracting large inflows in the early 2010s. Today, Black’s idea is more relevant than ever. Defensive strategies have demonstrated their resilience by outperforming during downturns such as in 2022.

However, the emphasis on relative performance often makes these strategies appear less appealing against an increasingly concentrated benchmark in bullish markets, as seen in the ongoing US tech rally of 2024.

## Broader risk of benchmarkism

The unintended consequences of benchmarkism extend beyond individual portfolios. By focusing solely on beating the benchmark, many institutional investors have become hostages to indices. This focus can lead to misallocation of capital, where risky investments become overvalued, and safer ones remain under-appreciated. A clear example of this was during the late 1990s tech bubble when technology stocks became grossly overvalued as they gained larger

and larger weighting in the indices.

Worse still, regulatory frameworks can reinforce this behaviour. In countries such as the Netherlands, corporate pension funds are required to explain why their performance deviates from the benchmark. Often, funds that pursue more defensive strategies are penalised. In Australia, the “Your Future, Your Super” law pressures investors to stick to benchmark-like returns, even when it might not be in the best long-term interest of their beneficiaries.

The result is that professional investors, bound by fiduciary duties and regulatory oversight, cannot reduce the absolute risk in their equity portfolio to avoid falling behind their increasingly concentrated benchmark, even in markets that exhibit speculative bubbles or systemic instability.

## The role of index committees

The influence of benchmark providers, such as MSCI, is another critical factor to consider. These committees wield immense power in deciding which stocks or countries are included in an index. Their decisions, often shaped by lobbying efforts, have profound implications for global investment flows.

Index providers are also lobbying to embed their benchmarks into regulatory frameworks. Recent moves in Brussels to incorporate Paris-aligned benchmarks into the Sustainable Finance Disclosure Regulation illustrate how the subjective choices of index providers can steer large-scale investment flows. Yet these indices are not always consistent.

For example, Nexans, a company central to the energy transition, was excluded from the Paris-aligned High Yield Index due to its carbon emissions, while Ford Motor – a largely carbon fuel-based automaker – was included. Such inconsistencies reveal the risks of relying too heavily on benchmarks.

## Benchmarks unchained: Is there an escape?

How can investors break free from the benchmark trap? Over the past decade, sustainable and impact investing has gained considerable momentum. As more investors adopt sustainability criteria, they are forced to reconsider the role of benchmarks. This shift encourages a rethinking of investment objectives.

By incorporating sustainability criteria and impact in their investment process, investors are starting to move beyond the narrow focus on relative risk and return to embrace a third dimension: sustainability. This opens the door to reducing benchmark dependence, prioritising absolute risk and fostering a clearer understanding of “knowing what you own.”

If professional investors adhere too strictly to benchmarks, market prices will increasingly be set by a small group of active players. The composition of this group is crucial, but there is no guarantee they will make markets more efficient. As we saw with the 2021 GameStop short squeeze, speculative retail investors leveraging high-risk positions can drive prices to bubble levels and push more disciplined investors who are focused on fundamentals to the sidelines.

The more investors align with benchmarks, the more fragile mar-

kets become as capital is allocated based on the composition of an index rather than fundamentals.

## Focus on fundamentals

There needs to be a broader rethinking of regulation and investment principles. Regulators, for instance, could focus more on absolute risk rather than relative risk when evaluating performance. This would shift attention away from short-term tracking error and instead emphasise long-term risk management. By focusing on a portfolio’s volatility or resilience during market downturns, rather than its proximity to the benchmark, investors can regain the freedom to make more thoughtful, risk-aware decisions.

Ultimately, the best way to beat the benchmark is to ignore it – at least in the short term. Warren Buffett’s famous rule, “Don’t lose capital,” should be the guiding benchmark for all investors. By focusing on absolute returns and minimising unnecessary risk, investors can avoid the distortions caused by benchmarkism.

Under-represented segments in benchmarks – such as small caps or defensive stocks – often provide compelling opportunities, especially in periods of increased market concentration like today. Similarly, fallen angels – bonds that are downgraded from investment grade to high yield – can become attractively priced due to forced selling by benchmark-driven investors. These inefficiencies are the investment opportunities that contrarian investors can exploit.

An investor’s edge might therefore come not from being smarter, but from being less constrained. Here lies the paradox: By letting go of the fixation on benchmarks and focusing on fundamentals and essential risks like losing capital, investors can unlock hidden value and achieve long-term performance – even outperforming the benchmark.

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