
“You can’t eat relative returns”

We were reminded of this line a few weeks ago by a client during a portfolio review. For years, investors have used this phrase to emphasize the difference between “absolute” and “relative” returns. It’s worth understanding this difference and the factors at play in this phrase.

Absolute return is the percentage return of a portfolio over a certain period of time. Relative return is the percent return of the portfolio relative to a benchmark (or index) – one similar to the portfolio strategy.

Here’s a simple example using a 1-year return for both a positive and negative year of portfolio return. In the positive year, the portfolio had an absolute return of +15% and the benchmark +20%, leaving a relative return of -5%. In the negative year, the portfolio was -10%, and the benchmark -15%, so the relative return was +5%.

Scenario	Positive Year	Negative Year
Absolute Return	+15%	-10%
Benchmark Return	+20%	-15%
Relative Return	-5%	+5%

At the end of the day, we invest to increase the value of our portfolio, which means earning a positive rate of return. That is Absolute return, and the degree of that return will depend on the types of investments, the risks assumed, and the time period being measured.

Relative return is primarily used to judge the effectiveness of an investment strategy or investment manager compared to the performance you might have reasonably expected to achieve by investing in the universe of a comparable investment class. In addition to performance, a true comparison should assess the amount of risk taken to achieve those returns relative to the risk in the benchmark. Over the past 20 years, the advent of numerous benchmarks based on asset classes, strategies, capitalization, quality, style, and many other factors has allowed cleaner relative comparisons. However, it has also added a lot of noise for investors to sort through, as there may be more than one relevant benchmark to consider. In addition to the type of investment and risk factors, a relative comparison must also incorporate an appropriate time horizon for measurement.

The time horizon for comparison should be long enough to account for economic and market cycles. The average length of a U.S. economic cycle is roughly 5.5 years, as measured by the National Bureau of Economic Research (NBER). However, there is wide variation in cycle length from 18 months to over 10 years. According to NBER, the average market cycle for the U.S. Equity markets is 6.25 years. Bull markets have averaged roughly 5 years, although some have lasted over 10 years, while bear markets (defined as a 20% decline) average just over 1 year. We believe 10 years is a useful rule of thumb, although the specific market cycle in progress may suggest that number should be longer or shorter, something we may only know accurately with hindsight.

So, how do we select an appropriate benchmark for comparing U.S. Equity returns? We believe the following characteristics are important:

- The benchmark should represent the universe of securities in which the portfolio is expected to invest.
- The benchmark must be relevant to the portfolio’s strategy and goals.
- The comparison is meaningful by matching the portfolio's investment style, sector focus, market capitalization, and geographic allocation.
- A good equity benchmark should be well-diversified across sectors, industries, and companies, depending on its scope (e.g., broad market vs. sector specific). Diversification reduces concentration risk and ensures that a few securities do not overly influence the benchmark.

Using an extreme example, comparing U.S. Equity returns to U.S. Treasury Bills disregards many of the characteristics above, including the difference in risk (volatility) and return potential between the two asset classes.

This discussion will focus on returns of broad-based U.S. Equity benchmarks or indices.

The S&P 500 is the U.S. stock market's most widely referenced benchmark or indicator. Comprised of the 500 most valuable companies on the US stock exchanges, it is a capitalization-weighted index, meaning the largest companies by market capitalization have the greatest influence on the index. However, it is not the only broad-based index covered by the financial press. Others are the NASDAQ, Dow Jones 30 Industrial Average, S&P 500 Equal-weight, Russell 3000, and the MSCI All-Country World Index (which includes US and international stocks).

We constructed the table below using these six broad market indices, measured their returns since 1990, and divided the results into 5-year periods ranked by best performing index to worst over the specific 5-year period.

Annualized Returns over 5-year periods							All Periods
1990-1994	1995-1999	2000-2004	2005-2009	2010-2014	2015-2019	2020-2Q2024	1990-2Q2024
NASDAQ 10.6%	NASDAQ 40.2%	S&P Equal 8.1%	MSCI ACWI 3.6%	S&P Equal 17.4%	NASDAQ 13.6%	NASDAQ 16.3%	NASDAQ 11.2%
DJI 30 10.3%	S&P 500 28.6%	DJI 30 0.7%	S&P Equal 2.3%	NASDAQ 15.9%	DJI 30 12.6%	S&P Cap 14.2%	S&P Equal 11.1%
S&P Equal 9.9%	DJI 30 27.0%	R 3000 AC -1.2%	DJI 30 1.9%	R 3000 AC 15.6%	S&P Cap 11.7%	R 3000 AC 13.3%	DJI 30 10.6%
R 3000 AC 9.1%	R 3000 AC 26.9%	MSCI ACWI -1.8%	NASDAQ 0.8%	S&P Cap 15.5%	R 3000 AC 11.2%	MSCI ACWI 10.4%	S&P Cap 10.5%
S&P 500 8.7%	S&P Equal 20.6%	S&P 500 -2.3%	R 3000 AC 0.8%	DJI 30 14.2%	S&P Equal 9.8%	S&P Equal 10.2%	R 3000 AC 10.4%
MSCI ACWI 4.7%	MSCI ACWI 19.2%	NASDAQ -11.8%	S&P Cap 0.4%	MSCI ACWI 9.7%	MSCI ACWI 9.0%	DJI 30 9.5%	MSCI ACWI 7.6%

As you can see by following the colors over the 5-year period, the results vary noticeably.

This table also reveals why long-time horizons are critical. Over the entire 35-year period, the range of annualized returns is quite tight. This is not the case over shorter periods. Someone who invested in equities between 1990-1999 (10 years) might be enviously eyeing the NASDAQ returns. Meanwhile, someone looking at the trailing 10-year period in 2009 would be upset to have done as poorly as the NASDAQ. Complicating factors further, the benchmarks' characteristics have changed dramatically over the past 35 years. The NASDAQ today is composed of larger, more established businesses than was in the case in the 1990s. For the S&P 500, the last five years have seen the largest ten constituents grow to almost 40% of the total index, creating a meaningfully less diversified benchmark.

Our position is not to become overly focused on a single benchmark comparison. Investors should be benchmark-aware, not benchmark-driven. Investment managers should provide clients with periodic reports on investment performance that include comparisons to appropriate benchmarks for all asset classes in which they have invested client assets. It is important to note that long-term return expectations begin with the asset allocation decision, something for which a true benchmark does not even exist. Investing in any asset comes with risk and volatility. That risk assumption should be rewarded over economic and market cycles with returns that exceed lower-risk asset classes.