SIGNAL RIDGE
CAPITAL PARTNERS

(617) 607-3222 | info@signalridgecp.com | www.signalridgecp.com

WHY BENCHMARK?

benchmark (bench·mark \bench-märk) n.
1 **something that can be used to judge the quality or level of other, similar things**

Benchmarking is an important but often misused exercise. Used properly, a benchmark should provide a reference point for what was possible in a given period of time. It should also allow one to evaluate their own strategy, understand their successes and failures, and improve their process accordingly.

USING THE WRONG BENCHMARK CAN LEAD TO POOR DECISIONS, PARTICULARLY IN FINANCE.
The average investor often benchmarks himself or herself to inappropriate things. In finance, the most commonly used benchmark is the S&P 500. The S&P 500 is a stock market index comprised of 500 large, U.S. companies weighted based on their size. While this is a reasonable benchmark for a portfolio made up exclusively of large American companies, it is not a good standard for evaluating the performance of a basket of foreign stocks. It is an even worse yardstick for a diversified portfolio of global stocks, bonds, commodities, and other asset classes. Benchmarking one's financial welfare to something that can suffer losses of 50% almost once every decade makes little sense to us.

Another benchmark that we humans sometimes use is comparing ourselves to our friends and neighbors. The phrase "Trying to keep up with the Joneses" is colloquial for a reason. This standard of comparison can be useful in some facets of life; e.g. for those of us that are athletes, improving our game is an integral part of competing successfully with our peers. Generally speaking though, it's more important to keep values and objectives in mind than comparing your car to the Joneses' shiny new car.

People also tend to look at a small period of time and assume that it is representative. For example, between March of 2009 and the end of 2014, the S&P 500 Index ETF (SPY) returned a total of 214.9%—or an annualized return of 21.7%. It's natural to hope for similar returns in the future. But such a scenario is unlikely to materialize going forward, so counting on such high returns is not realistic. Going back to the inception of the S&P 500 Index ETF in 1993, the annualized rate of return is less than half that of the past few years (9.4% per year). Today, given the recent run up in U.S. stocks, many pundits expect the S&P 500 to return less than 4.0% in the next five to seven years.

This "recency bias" will often cause investors to overlook details. From March 1989 to March 1999, the S&P 500 Index returned an annualized 18.8% per year. At that point in time it was also easy to see high future returns in a blossoming technology industry that was remaking the world. However, in the next 10 years the S&P 500 Index ETF had four selloffs of 10% or more, two drawdowns of more than 45%, and one selloff of about 55%. The average return for the S&P during that ten year period was a dismal -3.53% annualized. Someone who bought an S&P 500 Index fund in 1999 or 2007 would have been extremely disappointed with their subsequent returns.

At Signal Ridge, we are wealth managers with a fiduciary responsibility to our clients. As fiduciaries, our job is to understand and evaluate risks and manage client assets accordingly. It would be imprudent to invest all client assets in one asset or asset class. We also cannot simply look at returns from the last few years and project those forward (there's a reason that every performance report ever created contains the disclaimer "Past performance is not indicative of future results"). So we build global, diversified portfolios that acknowledge no one knows what will happen in the short term, while focusing

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energy on what we do know (cheap asset classes tend to outperform expensive ones in the long-run, mean reversion tends to come into play over time, any single asset or asset class can experience devastating losses in the short-run, and diversification benefits can add meaningfully to the risk and return profile of a multi asset portfolio—pardon us if this got a bit technical!).

SO HOW DO WE BENCHMARK?

Signal Ridge benchmarks at three levels. Our first and most important benchmark is developed in our financial planning process. As we quantify your goals and look to meet them over time, we establish a target rate of return that we seek to meet in the intermediate- and long-term. This rate of return is ideally sufficient to meet long-term objectives and is reasonably achievable. As we regularly update our progress, we evaluate whether or not you are on track to achieve your goals and evaluate the likelihood of doing so. This measure of your probability of successfully attaining reaching your goals is the benchmark that should matter most to you!

The second way we benchmark is by building two custom benchmarks that are representative of what one could achieve by opening an account at Vanguard and building a diversified portfolio of index funds. Signal Ridge uses two benchmarks for this purpose that we creatively call "Global Balanced" and "Global Blend." Our "Global Balanced" benchmark is a diversified, global, portfolio of index funds that is a variation on a 50% stock, 50% bond portfolio. In the long-run it should be a lower risk benchmark with an expected future return that seeks to exceed inflation by about 2% to 3% per year. Our "Global Blend" benchmark is also a global and diversified basket of index funds, but it is a variation on the traditional 60% equity and 40% bond portfolio. As such it has more exposure to stocks and has more of a domestic (U.S.) bias. In the long run, it should be more volatile (or risky) than the "Global Balanced" benchmark with an expected return of about 4% to 5% above inflation. Our general expectation for client portfolios is to fall somewhere between these two benchmarks. Signal Ridge intends to generate this result by protecting capital when markets fall and catching some—but not all—of the upside when they roar upwards, in essence by allowing compounding to take maximum effect by eliminating massive drawdowns.

The third and final way we benchmark is to assign a specific benchmark to each strategy we employ. These benchmarks allow us to evaluate our decisions to use certain index mutual funds or ETFs over others or actively managed funds instead of basic index funds. For example, if we are using an emerging markets stock fund for clients we want to know if it is preferable to owning a low cost emerging markets index fund. We also typically favor low cost index funds and choose active managers over passive indexes only when we think a manager can effectively manage risk. Our evaluation of that manager's skill is based then on the risk-adjusted return that particular investment provides.

These final two benchmarks are important to our internal process and to keeping our strategies on track, but should be less of a concern for our clients. We are always happy to review the performance of individual positions within our portfolios, but we hope that our process lends to focusing on the big picture.

TYING IT ALL TOGETHER.

Signal Ridge Capital Partners is in the business of helping our clients achieve their goals in the long-term. We help clients enhance their odds of achieving their goals by shifting the focus from the short-term (how did XYZ Fund do this past

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quarter?) to the long-term (am I on track to achieve my goals?). We focus on managing risk for a number of reasons. The first is simply that risk is more consistent and predictable than returns. The second is that by reducing the volatility of returns around an average return that meets a client's goals we are able to mathematically increase our client's odds of success. The third and final reason is perhaps most important—we all like to sleep soundly at night—life is stressful enough without having to worry incessantly about one's finances.

The Signal Ridge process revolves around gaining a thorough understanding of our clients' needs and goals, taking a long-term view, and harvesting returns from varied sources whenever available. Most importantly though, we seek to avoid the devastating losses inherent in stock market investing that so often derail investors' best laid plans. We will never be the shiny new Ferrari in the Joneses' driveway. But we like our odds of long term success.

SAM, JOHN AND JOSH
www.signalridgecp.com
or call (617) 607-3222

SAMUEL D. WEBSTER
swebster@signalridgecp.com

JOHN F. SMITKA, JR.
jsmitka@signalridgecp.com

JOSHUA M. STREET
jstreet@signalridgecp.com

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