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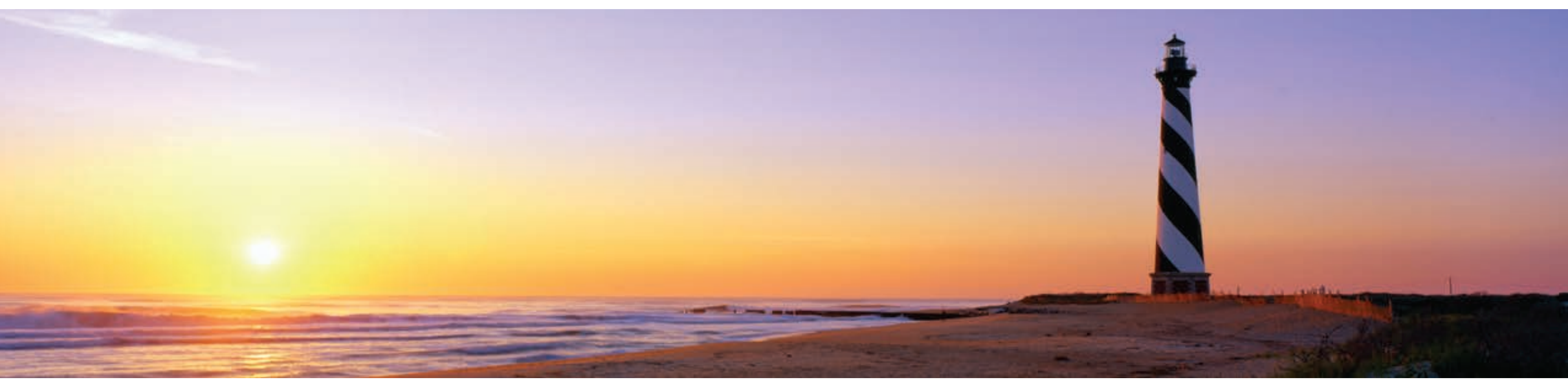

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Performance Evaluation

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Many investors improperly evaluate their portfolio performance, which often leads them to make inappropriate investment decisions. Developing thoughtful gauges of performance can help investors make more informed decisions and avoid knee-jerk reactions based upon short-term market conditions.

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Cover story continued.

For example, investors often suffer from "recency bias," which is the tendency to evaluate the performance of their portfolios based upon recent results. They feel good during periods of high returns and bad during periods of low or negative returns. Those "feelings" can cause them to take actions that negatively impact their wealth over the long term. Indeed, it is commonly recognized that many investors jump into booming markets near peaks (believing that recent good times will continue) and then get out of the market near market lows (out of fear of continuing declines).

We believe that investment performance should not be evaluated based upon most recent performance or in a vacuum. Rather, we believe that performance should be evaluated from multiple vantage points.

Your Portfolio – Your Performance

An investor should review performance based upon the risks undertaken in his portfolio. An investor who decides to take only the risks inherent in a bond portfolio should not be upset if her portfolio generates returns that are lower than say, technology stocks. Similarly, an investor who decides to invest in a portfolio comprised of a hybrid of bonds and stocks should not compare his overall performance to the performances of solely the stock market or solely of the bond market.

Investment professionals use benchmarks to evaluate performance. There are benchmarks for domestic stocks (e.g., the S&P 500 and the Wilshire 5000), industry sectors (e.g., financials, real estate), investment styles (e.g., value and growth), company size (large cap, small cap, etc.), international stocks (global, developed markets, emerging markets, etc.), bonds (taxable, tax-free, short-term, long-term, etc.), hedge funds of various varieties, private equity, and the list goes on.

Apples-to-Apples

The general notion is to measure performance relative to a benchmark or combination of benchmarks based upon the composition of your portfolio. If your portfolio is 40% bonds and 60% equities, it makes sense to compare overall performance to that blend of bond and equity benchmarks. And, the benchmarks should be chosen based upon the specifics of your portfolio. For example, if your bonds are all short-term municipal bonds, it would be inappropriate to compare their performance to an index of long-term taxable bonds. Similarly, if your equities are primarily large industrial companies, you should not compare the performance of the equities portion of your portfolio to the NASDAQ 100 index, which consists primarily of technology stocks. You'd be comparing apples and oranges.

Digging a bit deeper, it is possible to design a portfolio with passive or active strategies, or a combination of the two. A passive strategy (aka "indexing") aims to replicate a benchmark by replicating the benchmark's characteristics. The simplest way to do this is to buy the same securities as the benchmark in the same proportions. Passive strategies should have low tracking error, meaning that the strategy's actual performance should be quite close to the benchmark's performance. Not surprisingly, the fee for a passive strategy should be low because the manager is not being asked to do anything other than "blindly" invest in the benchmark's components.

Actively Different

An active manager picks stocks with characteristics that he believes will outperform the benchmark. The resulting portfolio will differ from the benchmark components on factors like the market capitalization, sector makeup, valuation and dividend yield. The greater the difference between the benchmark stocks and the stocks in the active strategy, the greater the potential performance difference between the two. Some active managers make significant bets that deviate from their benchmarks, while others make only little "tweaks." Indeed, some active managers invest quite similarly to their benchmarks and are derogatorily called "closet indexers" because an investor typically pays higher fees for active management than for a passive index manager.

While it is useful to compare long-term average returns, averages obscure the variability of those returns year-to-year. Investors in active strategies need to know whether outperformance is the result of luck or skill. A strategy could have an average return greater than the benchmark's, but the outperformance was caused by one lucky year amidst an overall trend of underperformance.

Tracking Error

Tracking error is a statistical method for evaluating the variance of relative performance and tells investors whether outperformance is consistent or not.

Positive tracking error indicates that the strategy's outperformance is a result of the manager's skill, although it does not guarantee that the strategy will outperform in any given year. It also does not indicate the level of absolute return.

Being an active investor requires discipline and patience as it can take time to reap the benefit of positive tracking error. Even the best active strategies will have periods of underperformance. Jumping ship only locks in losses, preventing recovery and additional upside.

So, the next time you have a great investment year (or not-so-great year), consider the bigger picture with a longer-term view. Avoid the perils of recency bias. Use appropriate indices based upon the nature and components of your portfolio. Avoid comparing your overall performance with the performance of a single market or stock. Remember that your portfolio was designed to address both risk and reward, so avoid short-term comparisons to a single market or stock that happened to provide outsize reward recently (and that may provide outsize loss later). Consider whether an active strategy pays you, over the long-term, for the risks taken and whether that performance is repeatable. Thoughtful performance analysis can lead to better decision making over the long term.

Trusting

YOUR BLIND TRUST

Blind trusts have gained increased media attention recently as the Donald Trump administration takes office. Some of our clients have asked whether they might ever need a blind trust. While most families will not, when duty calls affluent individuals to serve in state or federal elected positions or as political appointees, avoiding actual or perceived conflicts of interest may require them to sell or otherwise distance themselves from their assets.

To avoid the perception that official actions might be impacted by his or her business and investment assets, a public servant could sell all assets and invest in Treasury bills or other approved securities. As an alternative for those who wish to continue ownership of businesses, concentrated stock investments, real estate and other assets, a blind trust may be used as a shield to reduce or eliminate the official's involvement in and awareness of the assets.

Blind trusts protect public officials by shielding the official from the control and management of his or her assets. The trust is managed by a trustee who, as the trust's name suggests, will operate behind a curtain of secrecy. Based on the federal rules for "qualified blind trusts," the trustee may not communicate with the beneficiaries or other interested parties about the assets of the trust, except in very limited circumstances. Additionally, the beneficiaries may only communicate with the trustee in writing and only concerning limited issues.

Selecting the Trustee

Blind trusts' lack of transparency amplifies the importance of selecting the right trustee. Public officials may wish to select a family member or close friend whom they trust to serve in the role; however, federal law requires a trustee that is independent of the official. If a corporate trustee is used, its employees must be independent of the official.

The following questions provide a launching point for discussions with prospective trustees:

- What is your experience serving as a fiduciary for high-profile, public families?
- How does your organization protect confidential information from digital and socially engineered intrusions?
- Can you provide examples of unusual assets (e.g., real estate, mineral interests, closely held business interests, private equity, hedge funds, etc.) that you have held as trustee?
- Can you continue to hold the unusual assets or do your policies and practices suggest that you will divest the trust of them? Please provide examples of situations in which you have continued ownership and the processes you use for making decisions in this regard?
- Can you explain how you handle asset concentrations?

As these questions suggest, it is critical to find a trustee that is flexible and handles each situation based on its specific and unique circumstances. A rigid trustee may inappropriately sell legacy assets and replace them with standardized investments.

Prospective trustees also should provide information about the asset classes they utilize as trustee. The information should include investment performance about existing investment funds, as well as any investment vehicles that the trustee has terminated in the last 10 years, including the reasons for termination and how their performance compared to benchmarks.

When evaluating potential trustees, it is also important to inquire about the law and accounting firms they use. The public official will have no ability to select or influence the selection of professionals that work on the blind trust's matters, so learning about the caliber of the trustee's professional relationships is important.

Questions They Ask

When interviewing a prospective trustee, focus on the questions the trustee asks you. A thoughtful trustee will want to learn about your family, its financial values, and its multi-generational needs and goals. It is paramount that these conversations happen on the front-end, because once the blind trust is funded, the trustee will operate independently from the family.

After selecting a trustee, the federal official (state law varies) must submit the proposed trustee and trust instrument to the appropriate federal supervisory ethics office. Once the arrangement has been approved and trust has been funded, the official has 30 days to file the executed trust agreement and provide a list of all assets contributed to the trust. The trustee cannot provide the official with information about the transactions or assets of the trust. The trustee can provide periodic performance reports, but the information will be minimal. The public official's communication with the trustee generally will be limited to providing information about cash needs.

Once a public official's service is complete, the blind trust may be terminated and the official may resume active involvement in his or her financial affairs. The assets may differ considerably from what originally was contributed to the trust, but the trustee should be able to provide a well-reasoned explanation of the investment program employed during the official's service. Although no longer required, former officials often continue to allow their trustees to handle most of their financial affairs so they can focus on their other interests.

ANDREW B. SMITH, JD
Vice President and Senior Relationship Officer

To Freeze or Not to Freeze?

Have you considered freezing your credit, or that of your spouse or children? Doing so makes it more difficult for identity thieves to open new accounts in your name. That's because most creditors need to see your credit report before they approve a new account. If they can't see your file, they may not open the account or extend the credit.

A credit freeze does not affect your credit score or prevent you from getting credit reports.

A credit freeze does not stop you or anyone else from making charges on your existing accounts, so you will still need to monitor your credit cards for fraudulent transactions.

To initiate a freeze, you'll need to contact all three credit agencies (Equifax, Experian, and TransUnion), supply your name, address, date of birth, Social Security number, and other personal information. Fees vary based on where you live, but commonly range from $5 to $10 per agency. Each agency has its own process for freezing credit, so review their websites individually.

After receiving your freeze request, each credit agency will send you a confirmation letter containing a unique PIN (personal identification number) or password. Keep the PIN or password in a safe place. You will need it if you choose to lift the freeze.

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In addition to potential fraudsters, a credit freeze likely will keep you from opening a new account, renting an apartment, buying insurance, securing a line of credit or possibly even getting a job. If you're doing any of these, you'll need to lift the freeze temporarily. The cost is not excessive (approximately $5 - $10 per credit agency depending upon where you live) but it is time consuming. So, if you are just starting out or are the primary wage-earner on whose credit most transactions are based, we do not recommend a freeze. That said, credit freezes should be considered for children under the age of 18, a non-working spouse, and for you if do not use credit.

Should you decide not to freeze your credit, we recommend you register for a service which will notify you every time someone accesses your credit (e.g. ProtectMyID.com). This near-real-time information allows you to identify possible nefarious activity and react accordingly. That's obviously more effective than simply reviewing your credit report periodically. And, it's probably less frustrating and embarrassing than when you forget that you froze your credit and get turned down when trying to get that purchase discount by opening a store account!

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Sentinel Trust Company provides custom integrated planning, investment, fiduciary and administrative solutions to affluent families and their closely held businesses and entities.

Founded in 1997 as the successor to two 40-year old, investment-focused family offices, today Sentinel offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office and the in-house technical skills of independent planning and investment management firms.

For additional information about the topics presented in this newsletter, or to be placed on our mailing list for future editions, please contact Anthony DeToto at adetoto@sentineltrust.com or call 713.559.9578. You can find electronic copies of our past quarterly newsletters at www.sentineltrust.com/publications/on-watch/.

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