Benchmarking: A Small Investment with a Big Payoff

Portfolio benchmarking is the process of setting targets that pave the way to performance. It is used to help credit unions understand what investment characteristics ensure consistent performance. It also provides managers and supervisors with the means to measure how well the credit union is doing. Benchmarks define how any investment should perform and clarifies the risk position and income forecast over multiple interest rate environments. Once we understand the needs of the balance sheet, we can use those needs to guide portfolio decision-making and measure the results of each investment decision.

Credit unions are restricted from many investments that are included in several market indexes, so we must build a benchmark that is appropriate to each credit union's unique needs containing the following characteristics:

- Unambiguous
- Investable
- Measurable
- Appropriate
- Reflective of current opinions
- Specified in advance
- Accountable[1]

We suggest building benchmarks using basic investment portfolio characteristics. This passive benchmark is built using a U.S. Treasury securities laddered portfolio. This approach allows financial managers to see the impact of their decisions relative to a "decision-free" portfolio. By using multiple benchmarks, each with increasing exposure to interest rate risk, managers can also see the additional income gained with higher risk. Once the potential impact of higher risk on financial performance becomes clear, those managers can make informed decisions regarding the portfolio in many rate scenarios. Everyone will be on board with how to position the portfolio while staying within risk constraints.

Developing a proper benchmark requires an investment of time—time for leaders to understand the benchmark characteristics, to learn how to use the benchmark to achieve goals, and to relay that information to appropriate supervisory groups. Taking the time and energy needed to explore, develop, and properly use benchmarks will help both the investment manager and supervisors succeed. Providing the manager with a proper financial-performance goal regarding expectations and risk constraints mandated by ALCO, will help keep the manager focused on critical performance targets. Setting targets for the investment manager through benchmarking assures ALCO that the manager will maintain approved risk limits and still deliver acceptable returns.

Credit unions that invest money *and* time in benchmarking will make performance goals more attainable. They will make the road to success clearer and stay optimized for peak performance.

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[1] "Market Indexes and Benchmarks" by C. Mitchell Conover, PhD, CFA, CIPM, CFA Refresher Reading