



## The way of the warrior

A fund's benchmark is the  
ultimate guide to  
understanding how its  
manager is doing.  
Picking the right one is half  
the battle won.



The last Samurai warrior walked this earth more than a century ago, but the legend lives on in everything from Darth Vader's armour to cowboy movies to business management styles. While the Samurai are known for their military prowess, their mystique is rooted in "bushido," the disciplined code of conduct that demanded fierce loyalty, honour, spiritual devotion and the ability to focus deeply.

We bring this up because fund managers have a code of conduct as well. It's called the benchmark—the standard against which their investment prowess is measured. The right benchmark index should help investors understand an active manager's skill, what he or she uniquely brings to the fund's performance.

So, how can one know what constitutes a good benchmark? One rule of thumb is that it needs to pass what practitioners call the "SAMURAI" test:

## Specified in advance

The benchmark's rules have been established prior to the start of the manager evaluation period; in other words, the index is not cherry-picked or manipulated to improve relative results.

## Appropriate

The benchmark is **consistent with the manager's investment style** or area of expertise. The performance of a Australian large-cap fund should be measured against an Australian large cap index, not a global large-cap or Australian small-cap one.

## Measurable

The benchmark's return is readily calculable on a reasonably frequent basis, meaning that the index's individual constituents can be priced. This is key for exposures to smaller, harder-to-trade markets like frontier markets or certain types of bonds.

## Unambiguous

The benchmark's rules and constituent securities should be transparent and clearly defined.

## Reflecting a manager's full investable opportunity set

In order to understand how much skill a manager brings to a fund's performance, the benchmark needs to include its whole potential investment universe.

## Accountable

The manager views the benchmark as a world of acceptable investments and can explain deviations from it.

## Investable

It is possible for the manager to seek to replicate the benchmark's returns. (That would disqualify **Bhutan's Gross National Happiness Index**, for example.)

## Indexing rules

If these attributes sound familiar, it's because the SAMURAI can be applied to indexed products such as exchange-traded funds (ETFs). A well-constructed ETF rests on a well-constructed, rules-based benchmark, one that generates performance that's measurable, specific and transparent. And as with an actively managed fund, it also relies on a **manager with the expertise** and resources to track index performance efficiently and consistently for investors.

In other words, an index fund not only needs to deliver what it says on the label, it needs the best label to get the job done. That's good manager conduct—the investment warrior way.

## Want to know more?



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