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## Benchmarking and Indices

Investors and investment managers are constantly striving to monitor their performance against competitors and against the market. However, is benchmarking a portfolio against an index sensible, and more importantly does it add value to investors?

Since the peak of the market at the end of 1999, investors turned their attention away from maximising returns to reducing risk. There are two risks in investing in equities: market risk and specific risk.

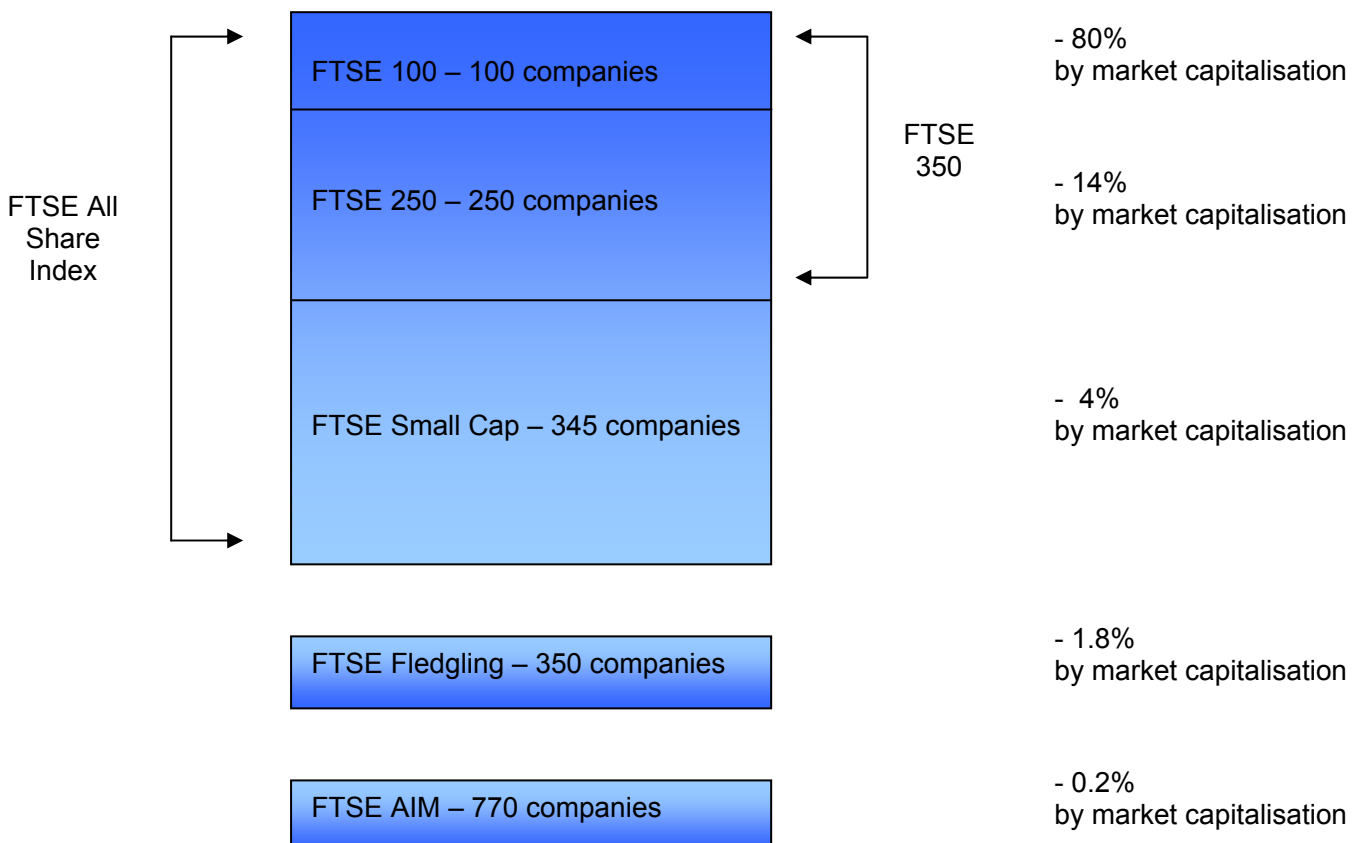
Market risk, as the name implies, is the risk of the whole Stock Market falling. In these circumstances nearly everything falls and so the risk is associated with being invested in the market.

Specific risk on the other hand refers to the risk associated with a particular investment; if that investment were to fall heavily, for instance in the event of a profits warning. The analogy of having all your eggs in one basket is often used.

It is for these reasons that investment managers try to benchmark against an index, by diversifying a portfolio across different sectors of the market, specific risk can be reduced and by investing globally the risk associated with a particular regions Stock Market can be reduced. However, if all global Stock Markets were to fall then losses would still occur.

### So how are these indices calculated and what are they?

In the UK, we have no less than 10 FTSE indices, ranging from the FTSE 100 to FTSE AIM with several in between and additionally we have indices for specific mandates such as FTSE 4 Good and FTSE TMT. These indices are calculated on "Capitalisation Weighted Index Basis", which in English means that the larger the capitalisation of a company is, the more influence it will have on that index.



As well as these indices, there are global indices, cross border indices, alternative investment indices, partner indices and APCIMS (Association of Private Client Investment Managers) indices. At this point it all starts to get a little confusing!

The APCIMS indices are simple; growth, balanced and income portfolios reflecting an industry average for weightings in bonds, UK equities and global investments, which are rebalanced on a quarterly basis. These indices are often used as a means of monitoring investor's performance and are an industry standard.

But are these indices of any use to private investors when monitoring how their portfolio is performing, and do they really reduce risk whilst maximising growth?

BRI's philosophy is that we have a conservative investment policy and so look to reduce risk whilst adding value. More importantly we believe that every investment decision should carry equal weight and be equally important. Each investment decision should have the ability to add value. Should BP, capitalised at £132 billion and therefore making up around 8 1/2% of the FTSE All Share, have more influence on the performance of your portfolio than an investment in, for example, 'St Modwen Properties', capitalised at £500 million making up just 0.4% of the Index? We don't think so.

Since the unification of Royal Dutch and Shell Transport & Trading to become Royal Dutch Shell this very point has been highlighted. Prior to the merger Shell was capitalised in excess of £46 billion; following the merger Royal Dutch Shell is capitalised in excess of £122 billion. This therefore means that Royal Dutch Shell has over twice the influence it had on the performance of the FTSE100. Should Investment managers double their clients' holding in Royal Dutch Shell simply in order to reduce the risk of not performing inline with the stock market or should they remain with their existing holding in order to reduce specific risk?

With the top 5 companies in the FTSE 100 making up over 40% of the index, we feel that there is significant specific risk if investors want portfolios to be weighted accordingly. History may repeat itself. It was not so long ago when Vodafone made up 15% of the FTSE 100 and Marconi 2.5%. If investors had been up to weight in these stocks then their portfolios would have fallen in line with the market, but this is not adding value.

BRI prides itself on not quasi-tracking an index and we endeavour to add value and outperform our competitors. We value our relationship with our clients, and it is only by having this close relationship that we can manage your investments to best suit your requirements.

**We would argue that benchmarking to an unrepresentative index does not necessarily produce a well diversified portfolio, and certainly takes no account of each client's individual needs. It is only by understanding and continuing to talk to our clients that allows us to provide a structured portfolio designed to meet their requirements.**

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