Absolute Or Relative: Why Focusing On The Right Thing Matters More Than Ever

By Vineer Bhansali| Aug 25, 2022

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Last week I completed my first self-supported, multi-stage, ultra-marathon “race” in Lapland, above the Arctic Circle. After more than 50 previous ultras, none of which have lasted more than a couple days, I spent almost a week in the swamps of Northern Finland, carrying a 25-pound pack (freeze dried food, energy bars, sleeping bag – in total 37 required survival items plus some optional ones). Almost 250 kilometers (155 miles) later, I made a few observations while as I ate handfuls of fresh blueberries along the way.

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The first observation is that in purely *absolute* terms one does not need much to survive. As long as there are plenty of calories (yes – lots of sugary foods), water to drink and cook, no injuries or bad health, and some shelter (I had a small single person tent) and warmth, humans can actually be very comfortable and sleep really well. At least well enough to run 20-25 miles each day and one 50-mile day aptly called the “long march”. You also don’t need that much experience either to complete the distance, just resilience. I was impressed by the 70-year-old gentleman from Japan who finished, and also the young couple from Mexico who spent their precious honeymoon running through the swamps. I presume they’re still married because she won the under 29 age group after placing responsibility for the trip on him. But *relatively* speaking, a comfortable bed, fresh food and a hot shower is absolutely great to have in life.

The second, and more important observation is that even though we were all moving in the same direction, checkpoint to checkpoint, and spending nights in the same camps, the element of “relative” ranking based on the total cumulative time crept into the psyche. Each of the six “stages” has its rankings and the winner of the race is the one with the lowest cumulative time over all six stages. Even though in absolute terms the route and the destination is the same, as humans I could not but pay attention to the time-based hierarchy or “ranking”, irrelevant as it may be in the bigger picture.

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After settling into my quartile of runners, I actually found myself running faster to go up just another notch, even though I had no chance of winning the overall race. I finished the first day at 45th, eased into 35th the next day, and then into 26th, and then on the last day into 24th overall. As I made the effort to go up a notch, I wondered why rankings and hierarchy are so important to us even though the competition is pretty irrelevant to the world at large.

Anthropologists who have looked at this question answer that having rankings establishes a pecking order and thus allows for structure within a group or society, whether for animals or humans. Having this structure somehow optimally conserves the resources of society at large by preventing chaos through order, arbitrary as it may be. For the higher-ranking individuals in ape society, more food and reproductive success is usually the result, even though maintaining the highest rank requires a lot of effort and can result in threats, real and imagined. For those who cannot rise to the very top of the heap, the local comparison to the ones around them establishes them in the ranking.

It seems that what I was doing, once I knew that I was not going to be in the top ten, was to subconsciously "benchmark" myself to a self-selected group of runners in my age group and sex, and see how I stacked up against them. By manipulating the categories and the number of members in these categories I can now make things look better in relative terms. For example: Without changing my absolute performance one bit, I was fourth in my age group and sex. Further stratifying by runners from Southern California, in my age group and sex, I think I must have won! So even though my absolute performance did not change one bit, after the fact I could change the benchmark and make my relative performance look really, really good, at least as measured against my handpicked benchmark.

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In financial markets, these concepts of absolute and relative superiority have been taken to extremes, since it may translate into tangible benefits; i.e. more money for those who can prove they are higher in the relative rankings. Each investment manager can pick a style, and then pick a benchmark to their liking, and by beating the benchmark, which can sometimes be like shooting fish in a barrel, the manager can show that "alpha", or outperformance relative to that self-selected benchmark. But the benchmarks can be changed after the fact. In a recent paper, *Moving the Goalposts? Mutual Fund Benchmark Changes and Performance Manipulation by Kevin Mullally and Andrea Rossi*, new evidence supports that many benchmarks are changed after the fact to show the same fund's performance in a better light. And this results in more inflows, and hence more fees for the managers, even though in absolute terms the investors may not be any better off (in fact they seem to be worse off).

While benchmarking to a certain degree is obviously good for decision making since it anchors expectations, taken to extremes it becomes just as silly as the stratification with my race described above. Sometimes tracking a benchmark can result in outright craziness, such as the many bond funds which kept buying negatively yielding assets in Europe as central bank buying of bonds depressed yields below zero, and because these bonds were in the benchmarks they followed.

In the stock market, passive index funds, and the monster-sized ETFs like SPY track the S&P 500 index, and have pulled in lots of investor money and may have also pulled in active managers who could not keep up with the passive funds. As long as the relative performance to the benchmark is positive, the manager(s) can say they are delivering value, and can charge high fees. And yes, if the market falls a lot, and the funds follow the benchmark over the cliff, as long as the relative performance is positive the managers will still be rewarded for providing “alpha”. If this does not work, at least according to current rules they can retrospectively switch benchmarks! Everyone gets a trophy!

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As market participants, we should realize that fixating too much on benchmarks can force us to miss the forest for the trees. Given the high prices of financial assets and low prospective returns today, the risk of this fixation translating into low absolute returns is much higher than ever. Whether it’s buying bonds at much too high prices and low yields, or buying stocks at much too high prices and high multiples, benchmarks can easily lull us into a sense of comfort, while hiding the fact that in the end absolute portfolio returns are what matter. You don’t retire on beating a concocted benchmark, you live off returns.

With inflation raging, the yield curve inverted, and asset prices vulnerable to sharp and turbulent selloffs, investors would be well advised to keep one eye on the prospective absolute performance of their portfolio, so that they don't end up in the position where their portfolio loses a whole bunch of actual money, but happen to do relatively better than some arbitrary benchmark. Relative returns are a way to keep score against peers and averages, but as the saying goes, you cannot eat relative return. And when it comes to absolute long term return generation, not losing too much money at any one time, i.e. survival and risk management is of paramount importance. This is why investors who are not blinded by the mirage of relative performance will do well to look at hedging downside risks in their portfolio in this period of unprecedented macro-economic transformation.

Important Disclosures

Vineer Bhansali, Ph.D. is the Founder and Chief Investment Officer of LongTail Alpha, LLC, an SEC-registered investment adviser and a CFTC-registered CTA and CPO. Any opinions or views expressed by Dr. Bhansali are solely those of Dr. Bhansali and do not necessarily reflect the opinions or views of LongTail Alpha, LLC or any of its affiliates (collectively, “LongTail Alpha”), or any other associated persons of LongTail Alpha. You should not treat any opinion expressed by Dr. Bhansali as investment advice or as a recommendation to make an investment in any particular investment strategy or investment product. Dr. Bhansali’s opinions and commentaries are based upon information he considers credible, but which may not constitute research by LongTail Alpha. Dr. Bhansali does not warrant the completeness or accuracy of the information upon which his opinions or commentaries are based.

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