How Tracking Error Impacts Your Clients' Portfolios

As an advisor, you have two big jobs, amongst a host of others, when it comes to your clients: keeping them invested and keeping them happy. And when it comes to the latter, there are certain measures you can take to make sure your clients are satisfied, even when the market takes a tumble.

To do that, you need a way to keep them level-headed about the performance of their portfolios. Tracking error can be one way to do just that.

What is tracking error and why does it matter?

Tracking error measures the performance of a portfolio relative to the benchmark it strives to replicate. It gives you an easy way to track the risk of the portfolio relative to a target, in terms of expected performance.

For example, if you are measuring your client's portfolio against the S&P 500, and the return for a particular period of time is 10% and you have a tracking error of 1%, most of the time your client's portfolio should have a return between 9% and 11%.

And if your client's portfolio has a return of 9% while the index has a return of 10%, you know you'll be asked about the negative difference. This can be a big piece to that puzzle that keeps your client happy and secure in their investment.

What causes tracking error?

Any deviation within a portfolio from the benchmark, likely an index, that you are measuring against will contribute to more error. Any tax-loss harvesting or Environmental, Social, and Governance (ESG) investing that changes the portfolio will result in some amount of error. The greater the difference in the portfolio, the greater the tracking error you can and will have.

How much error are we talking here? Direct indexing strategies will generally stay between 1%-2% tracking error, more active or thematic based strategies have 3%-6% , while a 100% cash portfolio on the S&P 500 will run about 15%.

Despite what you may be thinking, tracking error is not necessarily a bad thing. Remember that 9%-11% range we outlined earlier? If your client is on the 11% end of the spectrum due to electing to hold ESG investments that outperformed what was on the index, they'll probably be pretty happy with the result. Plus, you can intentionally increase your tracking error to get something of value in exchange, such as tax alpha or ESG benefits.

How do I control tracking error?

Controlling tracking error in a portfolio can be made easy by an SMA optimizer like ASTRO. Recalibrating the portfolio—whether annually, semi-annually, quarterly or even more frequently—can bring your portfolio back within the tracking error should it drift past the defined range. Being able to purchase the underlying securities of an index certainly gives you more flexibility to adjust to the market and optimize accordingly. Just note that optimizing the portfolio more often can incur more trading trading fees, which includes both implicit and explicit costs.

What are tracking error trade-offs?

The lower the tracking error, there are less actions an advisor can take for a client in terms of tax alpha. The frequency of the portfolio rebalance is something advisors and clients should work out based on tax-loss harvesting opportunities and market trends—as well as clients' risk, investment preferences, and unique goals.

But at least when a client calls asking why their portfolio underperformed the S&P 500, you'll have a concrete answer as to why. And it's not a bad thing, in most cases.

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