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The Sound Investor Series #31

Measuring 2005's Performance

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It is an interesting and useful to assess the financial market's yearly performance versus how your portfolio performed.

First, let's be clear about why we are doing this analysis. The goal is to measure your portfolio's relative performance and assure that you are on the right track. You are not trying to look at last year's performance to decide if money should be shifted from one asset to another. Asset allocation decisions should be based on long-term return expectations along with your age, health and wealth – not short-term market gyrations.

Monitoring your portfolio's relative performance gives you the opportunity to make "mid-course" adjustments, if necessary. We don't know how much the stock market will really go up in the future, but many of us use a long-term expectation of 8 or 10%. This allows us to make asset allocation decisions and calculate our savings needs and spending plans.

If we assume for a moment that the market does grow 10%, an investor's principal risk is that their stocks do not grow at the same rate and their investments lag the market. All the planning tools go out the window if you don't keep up with the market assumption and that's why it is critical to monitor relative performance.

If you find your investments falling behind the market by more than 1 percentage point a year - you need to make changes. One adjustment could be lowering your assumption of returns to reflect the sub-par performance. Alternatively, some investors could dramatically reduce their performance gap by shifting from active to passive investing strategies.

Before getting into 2005's details, let's use the Dow Jones Industrial Average (DJIA) to describe different ways investors consider returns - including price, dividend and total returns.

Price return only measures how prices have changed. When you read that the DJIA was down 0.61% in 2005, this is only its price return. While Dow investors lost 0.61% on a price return basis, they also received dividend income of 2.33%. Adding the negative 0.61% price return to the 2.33% dividend return gives a total return of 1.72%.

Bond returns are similar to stocks' except that they have interest income rather than dividends added to the price return to get their total return.

US stocks had a decent performance in 2005 with a total return of around 6%. The exact number depends on what broad-based index you use: the Dow Jones Wilshire index was up 6.32%; Russell 3000, up 6.12%; MSCI US, up 5.72% and S&P 1500 was up 5.66%.

A total return of 6% is the number you should use to measure the overall performance of a US stock portfolio. If you did better than 6% after costs, without taking on too many other risks, you did well.

2005 was an excellent year for international stock markets. Even though the dollar's strength defied expectations, Developed Markets were up 14% and Emerging Markets skyrocketed almost 35% when measured in US dollars.

The bond market did not do as well as the stock market. The benchmark 10-year Treasury Note had a total return of only 2.4%. Municipal Bonds did much better, up 3.5% - while investment grade corporate debt lagged Treasuries with a 2.0% total return. Unfortunately, but not unexpectedly, investments in money markets faired poorly, returning only 0.66%.

Most investors own mutual funds which should also be monitored; although this is not always easy. The biggest problem can be finding and deciding on an appropriate benchmark for comparison. One way around this problem is to use a benchmark that coincides with the reason you bought the fund. If you purchased a fund to give yourself exposure to the broad market, test the fund's performance against the whole market to see if it stacks up.

Another problem analyzing mutual funds is calculating their fees. If you bought a fund with a 5% load should you include that fee in the first year's performance, or spread it out over a few years? I recommend spreading it out for a fairer comparison.

In summary, investors need to monitor their investments to make sure they are behaving as expected. If you find investments consistently underperforming their benchmarks you need to make changes and get back on track.

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