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Investment Returns: The Apples and Oranges

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Today's column is about terms used to describe investment **Returns**. On the surface, Returns appear fairly simple, but as the details are explored, they become a little more complicated.

At the simplest level, **Return** is the money you make on an investment. Say you invest \$50,000 in XYZ Corporation for one year and make \$5,000. That \$5,000 is your **Dollar Return**. But in order to better describe investment returns we need to move beyond simple Dollar Returns where one of the problems is you cannot use them to compare two investments.

For example, let's say you also invested in ABC Corp. where you had a return of \$210 on a \$1,000 investment that lasted for two years. Which return was better: the \$210 from ABC or \$5,000 from XYZ? We see the \$5,000 is larger, but does that make XYZ the better investment? For a better apple to apples comparison we need to adjust for both:

1. Amount of money invested
2. Length of time invested

1. Adjusting for the amount of money invested is fairly easy. Instead of using the Dollar Return we need to use **Percentage Return** which is the Dollar Return divided by the amount invested. In the XYZ investment, you made \$5,000 on your \$50,000 investment for a 10% return ($5,000/50,000 = .10$). The ABC investment on the other hand had a 21% return ($210 / 1,000 = .21$) and now looks like the better investment.

2. But we need to adjust for the length of time invested. Most often this is done by looking at results on a yearly or annualized basis. For XYZ, this is easy since it was a one year investment - its annualized return is 10%. The ABC investment was for two years so we have to adjust its 21% total return. The temptation is to divide Percentage Return by number of years to get 10.5% ($21/2=10.5$). But this formula ignores the compounding effect of savings and overstates results.

The best way to take both money and time into account is to look at an investment's **Annualized Compounded Return**. ABC's 21% return over two years works out to an Annualized Compounded Return of 10% ($((1+.21)^{(1/2)})-1$). We now see that both investments were equal with Annualized Compounded Returns of 10%.

When specifically considering stocks, there are even more return calculations. A stock's return is often split between its **Price Return** - how much it goes up or down in percentage terms; and its **Dividend Return** (more commonly called **Dividend Yield**) which is its yearly dividend divided by the stock price. Adding the Price Return to the Dividend Yield is a stock's **Total Return**. Let's use the example of the XYZ investment and say of the \$5,000 return, \$4,000 came from the stock's price going higher and \$1,000 from dividends. So the Price Return was 8% ($4,000/50,000=.08$) and the Dividend Yield was 2% ($1,000/50,000=.02$) for a Total Return of 10%.

The bond market uses similar terms to the stock market but they say **Capital Gains** for Price Return and **Interest Income** instead of Dividend Yield. The two together are still the Total Return.

Yield-to-Maturity, another important term in the bond market, shows an investor's expected total return if a bond is held to maturity. Yield-to-Maturity takes into account both a bond's interest rate and the expected capital gain or loss as the bond moves from its current price to its redemption price at maturity.

Confusing and often misleading information about returns is a major concern and investors need to be careful. The **Average Percentage Return** is something to keep an eye out for as this number is meaningless if any of the returns are negative. For instance, if an investment gains 20% in one year and losses 20% the next, the average gain is zero. But if you invested \$100 and it gains 20% to \$120; and then loses 20% of \$120 or \$24, you end up with \$96 for a net loss, not a breakeven result.

Principal protected equity products are another area of concern as these products typically give investors participation in the upside of a price return index, not a total return index. They leave out the dividends so you **MUST** read the fine print.

In summary, investors need to understand the different ways of looking at investment returns. It's critical you read charts and graphs carefully and if you don't understand everything, ask what it means. It's your money, you have the right to understand and feel comfortable.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This series of articles is available at farmcreeksecurities.com. Before putting money in any investment, you should carefully consider your investment objectives; and the risks, charges and expenses of any investment. Past performance is not an indication of future performance and there are risks to investing including the loss of principal. Please contact Farm Creek for a prospectus on any of the funds mentioned.

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