

Putting some numbers on this will make it clearer. An investment of \$100 earning an annual compounded return of 10% for 20 years will gain \$572. If the investment earns 9%, it only gains \$460. The 10% portfolio will end up with 24% more income than the 9% portfolio.

The large effect of little differences in returns like this is why some brokers like me make such a big issue about investor's expenses. It's not that we believe low cost to be an end in and of itself. We all know that the cheapest product is not always the best or most appropriate solution.

But when it comes to investing, low cost is often the best answer. Historically, higher cost funds lag the market by a greater amount than the lower cost funds. Spending more in this case does not equal better. Unfortunately, investors do not get higher returns by paying more, if only it was that easy.

In fact high cost actively managed mutual funds, funds which try to beat the market, on average under-perform the market by about 1 percentage point a year. Low-cost index and Exchange-Traded Funds (ETFs) funds on the other hand tend to perform in line with the market or under-perform by a small amount.

In summary, the absolute performance of your portfolio is the only thing that matters at the end of the day. However, investors should use relative performance information to monitor their portfolios on a periodic basis. This will allow them to make changes to their portfolios and keep their investments on the right track.

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The Sound Investor Series #19

Performance Measures and Fees

by Ed Hynes, CFA

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As we all know, an investor's main goal is to have their portfolios perform well. When we retire, the absolute performance of our investments will determine how much money we have to spend.

Absolute performance is the only thing that counts. How our portfolios performed relative to the market or our neighbor's won't really matter. As they love to say on Wall Street, you cannot spend relative performance.

But in the years leading up to retirement, looking at the absolute performance of your portfolio on a year to year basis is less useful. Knowing the absolute performance of your investments does not usually help decision making. For instance, we expect stocks will be up some years and down others. Smart investors however, do not alter their investments due to short-term fluctuations in the market.

How should you monitor your investments in the short-term? How do you know if the money you invested in stocks is doing what you expect? This is when analyzing your portfolio's relative performance, rather than absolute performance is important.

If your equity investments are in large capitalization stocks you might measure the portfolio's performance relative to the S&P 500. You are looking to make sure your investments keep up with your benchmark.

Here's an example. If the stocks you owned were up 9% last year, did you do a good job or a bad job? Should you be pleased? On an absolute basis you made money, so it looks pretty good.

But if I tell you the S&P 500 was up 10%, now what do you think of your performance? You are still happy you made 9%, after seeing that the market did better. On a relative basis, you underperformed by 1 percentage point.

Does this under-performance matter, since you still made money? Well, if you have based your retirement spending on your stocks growing in line with the S&P 500, it certainly does. If the S&P 500 grows at its long-term average of 10% and you lag by 1 percentage point a year and make only 9%, your absolute performance won't be nearly as good as you planned.