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The Sound Investor Series #4

Measuring Your Investment Results

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One of the most important aspects of investing is determining your portfolio's performance. This article will help you understand some of the basics.

As we all know, numbers can be used to describe almost everything. This is true when it comes to measuring investment performance and investors need to be careful. You need to know what different terms and numbers really mean. Most importantly, investors need to understand that performance can be looked at in **absolute** and **relative** terms and that both, used correctly, are critical for managing your portfolio.

- Absolute performance simply measures how much a market or investment has gone up or down.
- Relative performance compares the returns of two investments and is usually expressed in percentage points.

Here is an example. If a market (i.e. S&P 500) goes from 100 to 110, it has gained \$10 or 10%. This 10% gain is its absolute gain. In the same period, if your mutual fund went from 100 to 109, its absolute performance is a gain of \$9 or 9%. On a relative basis however, your mutual fund underperformed the market by 1 percentage point. In another example, if the market is down 15% and your mutual fund only falls 12%; your fund's relative performance is a positive 3 percentage points.

Which is more important, absolute or relative performance? That depends on where you are in the investment process and what you are trying to measure.

When you retire and need your money, will you care how your portfolio has performed on an absolute or a relative basis? Of course, absolute performance is what matters. If you made money that's good, if you have lost, that's bad. Who cares about relative performance? It does not matter how your portfolio performed compared to the market. As Wall Street loves to say, you cannot spend relative performance.

However, when making shorter-term investment decisions to manage your retirement savings, absolute performance information is not very helpful. If you are invested in the stock market, you expect it will be up some years and down others. Hopefully, your investment plan is not to buy when the market is up or sell when it is down.

Relative performance information, on the other hand is very helpful for making shorter-term or tactical decisions. It is especially important for you to know how your stocks are performing relative to the stock market and your bonds relative to the bond market. So, how do you define and measure the market?

Investors need to choose an index or benchmark which represents the markets in which they invest. For large US stocks, a common benchmark is the S&P 500. For small stocks, the Russell 2000 is often used. There are many good benchmarks for the whole stock market including the S&P 1500 or Russell 3000. It is important for you to pick one or more benchmarks which accurately reflect your goals and the types of investments you own.

Make sure you compare your investments to the correct benchmark or else it is a waste of time and effort. Within the stock market, make sure you do not compare a mutual fund investing in “small” companies to a “large” company benchmark like the S&P 500 or vice versa. Likewise a government bond fund should not be compared to a junk bond index.

Your goal in measuring relative performance is to see if your long-term investments are moving in line with or close to your benchmarks. If there is a large negative performance gap over time, you need to make changes.

For a variety of reasons it is very difficult to outperform market benchmarks and the main problem being investment costs. This performance gap and methods investors can use to narrow it will be discussed in a future article.

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. (203) 838-1025. This article is the fourth in a series on basic investment topics 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.

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