

The Sound Investor Series #82

Measuring the 2006 Performance of Your Investments

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Let's pose two questions...how did your overall investment portfolio perform in 2006?
And how did each individual investment do?

These sound like such simple questions, but for most investors they are anything but easy to answer. Even seasoned financial professionals get hung up analyzing their own results.

But don't give up. Coming to grips with the answers to these questions is one of the most important keys to successful investing.

I know some readers will quickly move on to the next article. They mistakenly think that just because they have "other people" managing their money, they are set and don't have to worry about this stuff. In fact, nothing could be further from the truth. Investors who put their investment decisions into other people's hands are the ones that really need to carefully monitor how their portfolios are performing.

Let's start by looking at the second question, which is easier and I will cover the first question next week. It is important to realize that a stock's return comes in two forms: the change in price and dividends received. Many investors get confused here and you need to be careful. When returns are labeled "price return" it is easy to understand the return is just from the price change. When returns take into account both price changes and dividends received, they are called "total returns." Many times, tables of index and stock returns are not labeled and it is impossible to determine what is being presented.

To gauge how an individual investment performed, it needs to be measured or benchmarked against an index which measures the return of similar investments. For instance, if you have a mutual fund that invests in large U.S. stocks, an appropriate benchmark is the S&P 500 as it measures how all the money invested in those 500 stocks performed. This would also be a good benchmark for a portfolio of large stocks you might own.

Comparing, or measuring your investments against the wrong benchmark will be misleading. For example, if you have a mutual fund that invests in short-term bonds, it would not make sense to compare its performance to a large stock index like the S&P 500. Even measuring a fund that invests in small stocks vs. the S&P 500 would be a mistake.

Last year was a good year for stocks of all sizes and the total return of the S&P 500 was 15.8 (the price return was 13.6 percent and dividends added 2.2 percent. All of the remaining numbers will be "total returns"). The S&P 400, which tracks mid-cap stocks, was up 10.3 percent. While the Russell 2000 index, which is a good index for benchmarking small stocks, did even better with a return of 18.4 percent. For the whole

market; large, medium and small stocks as measured by the Dow Jones Wilshire 5000 index clocked a 15.9 percent return.

International stocks had an even better year. One thing to watch out for with foreign investments is that the performance information is often shown in two ways: how the stock market did in local currency terms and its performance as measured in U.S. Dollars. The developed markets (like Japan and Western Europe) rose 16.5 percent in local currencies, but 26.3 percent in U.S. Dollar terms. This “extra” performance for “Dollar” investors was caused by the Dollar weakening over the year.

Emerging markets which include countries like China, Russia and Brazil outpaced most investments, being up 28.5 percent in local currencies and 32.1 percent in U.S. Dollars. Putting this all together, the world’s stock markets were up 20.1 percent when measured in U.S. Dollars.

The bond markets were mixed in 2006. Longer dated U.S. Treasuries were up only 1.8 percent while intermediate Treasuries returned 3.5 percent. (Total return for bonds includes price change plus interest income.) The standout in fixed income markets were junk bonds which returned 11.8 percent. Municipal bonds had a total return of 4.8 percent. Most of this return came from tax-free interest and I will discuss that wrinkle next week.

With this information, investors should carefully compare their investments to the appropriate benchmark. If your mutual funds outperform their benchmarks - that’s great. But if they lag, especially over a period of a few years, it is probably time for a change.

Another potential problem for investors is being lured into comparing their mutual funds with other funds, rather than the market. This is dangerous because most funds underperform the market over the longer term. For instance in 2006, as we saw above, the S&P 500 had a total return of 15.8 percent. However, mutual funds which invest in large cap stocks returned 13.4 percent or 2.4 percentage points less. Your goal should be to match or beat the market, not to match or beat a bunch of other mutual funds.

One comment I hear from investors all the time, especially after a year like 2006, is my stock funds did just fine, most were up around 10 percent which is my long term goal. The problem with this train of thought is that investors need to make a lot more than 10 percent in some years because other years they will experience falling prices.

In summary, if you want to earn the long-term returns offered by the market, you need to monitor your results and keep up with the market’s gains year in and year out.

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