

The Sound Investor Series #83

Analyzing the 2006 Performance of Your Investments

Ed Hynes, CFA
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Last week I posed two questions: How did your overall investment portfolio perform in 2006? And how did each individual investment do? That article went on to discuss the second question and review the performance of various asset classes. For readers that missed that piece the performance information is at the end of this article.

Today, I want to look at the first question in more detail – “how did your overall portfolio perform in 2006.” To answer this question you need to create a benchmark portfolio with an asset allocation that mirrors your real portfolio.

If you went into 2006 with a fairly conservative portfolio, let’s say 50 percent of your money in large U.S. stocks and 50 percent in intermediate Treasuries, it is critical that you measure your results against a benchmark portfolio with the same asset allocation. To measure your portfolio versus a benchmark that consisted of all stocks or all bonds, does not make sense.

In the following example, the benchmark portfolio has half it’s assets in the S&P 500. With the S&P 500 index rising 15.8 percent last year, these stocks contributed a 7.9 percent gain to the entire portfolio ($0.50 * 15.8 = 7.9$). The 50 percent invested in Intermediate Treasuries gained 3.5 percent and therefore this asset contributed 1.75 percent. Adding these numbers together shows the benchmark portfolio gained 9.65 percent ($7.9 + 1.75$).

If an investor with this portfolio gained more than 9.65 percent, they did well. If not, it is important they figure out why and plan to do better going forward. This is really where the rubber meets the road with investing – investors need to keep up with their benchmarks in order to have any hope of their money growing as they expect.

From this example, we can also see why asset allocation is so important. Using the same two assets but with 80 percent in stocks and 20 percent in bonds, it has an expected return of 13.4 percent ($(0.8 * 15.9) + (0.2 * 3.5)$). This is 3.75 percentage points higher than the 50/50 benchmark.

Most real portfolios will have more than two assets and every investor’s benchmark portfolio will be different. Now get a pencil and paper; or a spreadsheet, and calculate a benchmark portfolio based on your asset allocation. If you need help or have a question, send me an e-mail or give me a call.

After you determine how your portfolio performed overall, you can probably easily trace the reasons you did better or worse by looking at the performance of each asset class from the ideas I discussed last week.

Most investors will find that their mutual funds underperformed the benchmarks and be very frustrated that they didn't do a better job picking funds. Don't beat yourself up, too much - most mutual funds under-perform, especially over the longer term. My advice is to work smarter, not harder; by using low-cost index funds so you can be sure of tracking your benchmarks. Low-cost index funds are available in the traditional mutual fund format through companies like Vanguard or in the form of Exchanged-Traded Funds (ETFs).

Many investors tell me they don't use index funds because they want to outperform the market. I understand this sentiment as most of us, including me, are overly optimistic and hate to be average. Try appeasing your ego by appreciating that although an index fund will not beat the market, it will still beat about 70 percent of other mutual funds.

We all know taxes have a tremendous affect on investors' actual returns. I wish I had an easy way for people to incorporate taxes into their performance analysis, but I don't. However, it is important to remember how different investments are taxed. Interest payments and short-term capital gains are taxed as ordinary income. On the other hand, long-term capital gains and qualified dividends are taxed at a preferential rate of either 5 or 15 percent depending on your tax rate.

When an investment's gain is actually taxed is also a key consideration. Interest payments and dividends are paid at regular intervals and taxed immediately. There's not much investors can do to control this. Capital gains on the other hand are taxed when they are realized and can be controlled to some extent. Investments that generate long-term capital gains which we can delay incurring for many years are more valuable than investments with the same pre-tax return that throw off short-term capital gains on a regular basis.

Let's look at an example to illustrate this point where an investor's marginal tax rate is 35 percent on ordinary income and 15 percent on long-term capital gains. One investment is a S&P 500 index fund and the other is a high-turnover hedge fund generating short-term capital gains. After 10 years, if the price gain of the S&P 500 is an annualized 10 percent (ignoring dividends) the after-tax gain is 135 percent. To get the same after-tax return from the hedge fund its pre-tax return would have to be 13.75 percent, which is 37.5 percent greater.

Another consideration is that the interest on Municipal Bonds is generally tax-free so we need to be careful when comparing their returns to the pre-tax return of other investments.

Here are the total returns for 2006 of a few asset classes. Total U.S. market - Dow Jones Wilshire 5000 (15.9 percent); Large caps - S&P 500 (15.8); Mid-cap - S&P 400 (10.3); Small-cap - Russell 2000 (18.4); International Developed markets in Dollars - EAFE (26.3); Int. Emerging markets in \$ (32.1); All stock markets (20.1); Longer-dated U.S. Bonds (1.8); Intermediate Treasuries (3.5); Junk bonds (11.8); and Municipal bonds (4.8).

Ed Hynes, CFA, is President of Farm Creek Securities, LLC based in Rowayton, CT. Comments are always welcomed at (203) 838-1025 or Ed@farmcreeksecurities.com. Farm Creek is a registered broker-dealer and investment adviser and member of the National Futures Association. This series of articles is available at farmcreeksecurities.com.

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