



Assessing Investment Performance

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Do you know how your portfolio is doing? Sadly, many investors don't. The area of performance measurement is often a muddy or neglected task. The wealth management industry doesn't help matters. Its lack of effort in providing useful information borders on negligence.

Yet, assessing performance is a key element of being a successful investor. The "Am I up or down this quarter?" approach doesn't cut it. The timeframe is inappropriate (too short term) and there is no context to it.

At Steadyhand, we recently published a framework to help investors assess their performance. Our approach, which emphasizes practicality over perfection, follows five steps:

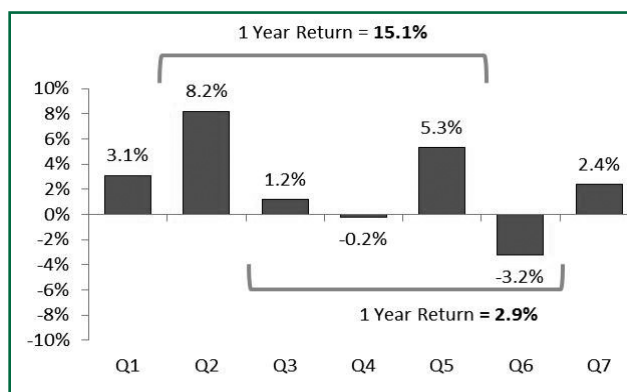
1. Numbers – gathering the facts,
2. Context – the market environment,
3. Analysis – how am I doing?
4. Success – factors impacting future returns, and
5. Actions – now what?

In this article, I provide a condensed overview of our approach. The complete framework (document) is available at www.steadyhand.com. Our methodology applies to evaluating a portfolio of mutual funds, but can be applied to individual securities as well.

Numbers

To determine how you're doing, you first need the facts. It's important to look at all your investments at one time, as it's the overall results you're interested in. It's also essential to make sure the data is for the same time period. Comparing numbers from periods ending on different dates renders the analysis useless. A difference of one month or quarter can have a significant impact on the conclusions as investment returns are very sensitive to the start and end dates of the measurement period, as Chart 1 illustrates.

CHART1: END-DATE SENSITIVITY



Unfortunately, investment returns are not always clearly displayed on account statements, so you may need to do a little digging. Useful sources of performance information include Morningstar (www.morningstar.ca), Globefund (www.globefund.com), and fund company websites.

The metric you should focus on is the *annualized rate of return* (the percentage return earned per year on your invested capital). As for the timeframe, you should focus on five-year numbers and longer. Focusing on short-term performance is not a productive exercise, as there are too many random factors at play.

Once you've compiled the numbers, we recommend analyzing them in two ways. First, determine the annualized returns for your overall portfolio. Second, examine the rolling returns, which are simply the annualized returns at different end dates (for example, the 5-year returns as of December 31, 2006, 2007, 2008 and so on). You may need to do some digging or compute the numbers yourself, but using rolling returns can help avoid the impact of end-date sensitivity.

Context

Once you've compiled the appropriate performance

numbers, the next step is to make an apples-to-apples comparison to a benchmark that best reflects the composition of your portfolio. Evaluating a balanced portfolio (stocks and bonds) against the S&P/TSX Composite Index, for example, is not an appropriate comparison.

To best represent the market environment that your portfolio has been operating in, you need to calculate the returns for a default portfolio based on your Strategic Asset Mix (SAM), which is the mix of investments that has the best chance of achieving your goals. If your SAM is 30% Canadian equities, 30% global equities and 40% Canadian bonds, your default portfolio should be 30% S&P/TSX Composite Index, 30% MSCI World Index and 40% DEX Universe Bond Index. You can calculate a default portfolio return as follows:

Asset Class	Index	SAM %		5-Year Return		
Bonds	DEX Universe Bond Index	40%	x	5.3%	=	2.1%
Canadian Stocks	S&P/TSX Composite Index	30%	x	6.5%	=	2.0%
Foreign Stocks	MSCI World Index (\$C)	30%	x	-0.8%	=	-0.2%
Default portfolio return						3.9%

Analysis

Now that you have the facts and understand something about the investing environment, it's time to do some analysis. How has your portfolio performed compared to your objectives and the default portfolio? What are the reasons for the good or bad performance? And who is responsible?

Your return objectives can take many forms (e.g., inflation plus 3%, GICs plus 2%, or a fixed return of 6%). The investing environment will have the most impact on how you've fared versus your objectives, but you also want to know how you've fared in relation to that environment. Or, more specifically, how you've fared versus your default portfolio. To answer this, we recommend doing analysis at four levels – asset mix, security selection, risk and cost.

• **Asset mix** - If you pursue strategies where your portfolio diverges significantly from your SAM, then asset mix will have a meaningful impact on how you've done. Carrying extra cash, more foreign stocks or loading up on corporate bonds are all examples of asset mix strategies. You need to determine how your positioning worked out over the period being analyzed.

• **Security selection** - How have your individual holdings done in the context of the market? Which investments

have added or detracted value? What are the reasons for the outperformance or underperformance?

• **Risk** - Not all 6% returns are the same. The path taken to get there can be very different – steady growth, volatile ups and downs, and everything in between. You should be cognizant of how each investment achieves its return and be comfortable with the potential level of volatility of each of your investments.

• **Cost** - There are many costs to investing, including administrative charges, management fees, and trailer and trading commissions. There's no upside here. These costs only detract from your returns. The question is: How big an impact did these fees and other costs have?

Success

A key part of a performance review is assessing how the past is likely to impact the future. If an investment has done well or poorly, what does it say about the potential for future returns? It's counterintuitive, but good returns over the last 1-3 years often presage lower future returns, just as periods of poor results can set up a good run in the other direction.

As for underperforming investments, it's important to understand why a holding is lagging and how long it has persisted. If the underperformer looks a lot like the kind of asset you like to buy – for instance, undervalued, out-of-favour stocks – then further patience may be required. It may even be a good time to buy more. Similarly, it's important to understand why something has done well. There is a natural tendency to deal with the dogs and leave the stars alone. Bonds, for example, have performed well over the past 30 years as interest rates have steadily dropped. It's unlikely, however, that bonds will provide the same kind of returns over the next decade or more. It's important to look at your stars and dogs with an objective eye to determine where the opportunities are and aren't.

Beyond past performance, it's important to assess the people, philosophy and process of your money manager(s). Are the professionals you trusted your money with still there? Has their philosophy or process changed? Are your "active" managers being truly active or are they just mirroring the index? This is the softer side of the analysis and can be difficult to determine, but it is nonetheless important.

Action

When you come to the end of a performance

assessment, there will likely be some adjustments to make. But as Warren Buffett suggests, your bias should be towards inaction. The question is: Do the things uncovered in the analysis require you to take action? And more to the point. How much under/overperformance should you tolerate and for how long? There are no easy answers here. There are situations, however, that should tip you off that action is required. For example:

- Consistently poor performance - If a fund has not met its objectives over longer periods and its rolling returns give you no reason for hope, it's time to move on.
- Change of key personnel - When a key manager leaves, you need to reassess your position.
- Changes to investment philosophy - A change of investment approach or objectives requires that you go back to square one.
- Performance inconsistent with the mandate - Investment returns are unpredictable, but over time you have an expectation for how an asset should perform. If a fund produces returns quite different from what you expect, e.g. more volatile or too much like the market indices, then it's time to look for an appropriate exit point.

- Excessive fees.

There are also factors which suggest that more patience is required:

- Short-term pain - Recent performance alone is not a reason to make changes to your portfolio.
- Experience and long-term track record - It makes sense to give a manager more time if they've proven their skill over a long period.
- Aggressive managers - If your manager is striving to generate returns well in excess of the market, then you have to expect that returns will deviate meaningfully from the benchmark.
- Extreme trends - There will be periods in a market cycle when a particular type of security is dominating and nothing else is working.
- Asset classes - If it's an overall asset class that's lagging (e.g., U.S. stocks), as opposed to a manager, you truly need to take a long-term view.

In sum, monitoring your portfolio is an essential part of being a successful investor. It's not enough to say, "My portfolio is up, I'm OK." or "I'm down, time for a change." We recommend doing a thorough performance review once a year. While it takes time and can be tough to do, it can save you a lot of grief and lost returns down the road.

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