

How is my portfolio doing?

In the world of goods and services, customers usually have a pretty good “feel” for the value of a purchase in a relatively short period of time after the transaction. If you hire a painter to paint your house, for instance, a post job inspection will probably give a good indication of the quality of work you have received. After an automobile purchase, most car buyers will be able to adequately assess whether or not they are pleased with their purchase within a few months. Unfortunately, in the investment management world, things are not so clear. Certainly you are probably able to judge whether or not your advisor has been responsive to your requests, but assessing portfolio performance, which is the real product you are buying, is much more difficult to figure out. In fact, it is often handled in a crude and subjective manner. The purpose of this article is to provide some insight as to how investors might be better equipped to assess their portfolio’s performance, taking into consideration a myriad of issues that may distort the task. It also sheds some light on how we at Milestone are accountable to our clients for performance measurement.

1. Comparing results to objectives.

Every journey has a starting point and a destination. Add a map, and travellers will have little difficulty assessing their progress towards the goal. Investment management is actually quite similar. It should start with a clearly identified statement of objectives to help assess performance down the road. A clearly defined measurable objective which provides the framework for evaluation might look like this: “The purpose of these funds is to provide me with a comfortable retirement once I reach the age of 60. Adequate growth above inflation and taxes is therefore required over the next twenty years. Following that I will require an estimated \$50,000 in annual income for the rest of my life.”

With the help of a sophisticated computer program, we can calculate an annualized return that shows how fast the portfolio is growing annually. Obviously all additions and withdrawals to/from the portfolio must first be “netted out” as they distort results. Then, by allowing for inflation and taxes, an investor (or manager) is able to determine bottom-line results. This calculation is called a portfolio’s “absolute” return, and it is a good start to assessing performance. Any investment advisor should be providing this to clients at least annually.

2. Comparing results to alternatives.

The next step in gauging progress is determining whether you have the best mode of transportation for the journey. Therefore, comparing alternatives is necessary. In investment management, it is asking the question: “How would I do if I chose a different investment program, advisor or firm?”

We subscribe to Morningstar Bellcharts, a database of the monthly performance for all Canadian mutual funds (now over 4,000). Almost all investment managers in the industry are represented as they generally manage mutual funds and as such provide a reasonable proxy of an investor’s alternatives. By using the median (the average

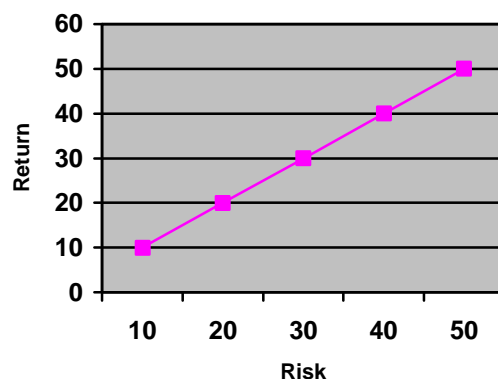
manager) or even the top quartile manager (meaning 75% of the managers have done worse) within a category, clients can see a close proxy of other alternatives. Obviously comparisons must be made on an “apples to apples” basis – for example, Canadian bond returns measured against other managers managing Canadian bonds or American small companies measured against managers managing American small companies. These numbers are shown on an after-cost basis (including fees). Since larger portfolios (over \$300,000) have less expensive alternatives available to them (vs. mutual funds at 2.5% annually on average), some allowance should probably be made for this difference in fees. By adding one percent annually to the median or top quartile manager’s return, we can accommodate for the difference. Also, some estimation of survivorship bias (the fact the statistics do not include defunct mutual funds) and taxes should be factored into the equation. All these adjustments should result in a number which fairly demonstrates how well alternatives are doing.

Besides this, comparisons should also be made to relevant indexes, as these are now accessible alternatives for investors since the introduction of Exchange Traded Funds. For example, one should compare returns of large company U.S. stocks to the S&P500 to gauge progress against these alternatives.

Where possible, we also compare our results to the investment program a client has followed previously to give them a good indication if better value is being received. Consider a case where someone might have previously invested their portfolio in an assortment of Guaranteed Investment Certificates offered by their bank branch. By comparing their current returns (and risk) to an index of 5-year GICs, they are well equipped to judge our added value. We can’t always make this comparison because sometimes it is impossible to determine how a former manager would be investing in the current environment, but we try.

3. Factoring in risks.

Lastly, it is important to remember erratic driving leads to accidents. Formal investment management theory states that no return is achieved without a taking a commensurate amount of risk to get it. So if the risk free rate of return (usually considered the rate on short term Government debt) is 3%, achieving 9% is only possible by multiplying the risk, other things being equal (see the chart below).



Portfolio measurement must be assessed with this in mind. For instance, if a manager achieves a 15% return on a portfolio with conservative objectives, he/she should probably be fired, as it could not have come without an unjustifiable level of risk. "Reversion to the mean" is inevitable over time and that means a loss of similar magnitude is likely to follow shortly.

This step in gauging performance is much more subjective than the first two, but necessary nevertheless. Investors should be asking not only how their portfolio has done, but also importantly, what risk level has been taken to get it. What might have happened under a different set of events? For instance, risks associated with large positions in one stock, regardless of how things actually turned out, should be considered in hindsight. Many Canadian investors have learned this painful lesson about risk with Nortel, which did unbelievably well for several years, only to fall disastrously in the end.

By taking these three steps, investors will be better equipped to decide if they're on course to achieve their financial goals in the best way possible. Sometimes, the results of this process are surprising: they may justify replacing an investment manager who is providing returns over 10% (if alternatives are even better or if risk is inappropriate) or commending one whose absolute results are negative (if alternatives would have been worse). But most importantly, the assessment is based on fair benchmarks which bring clarity to an often confusing process.

Milestone Investment Counsel Inc.

May 13, 2002