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for investment professionals

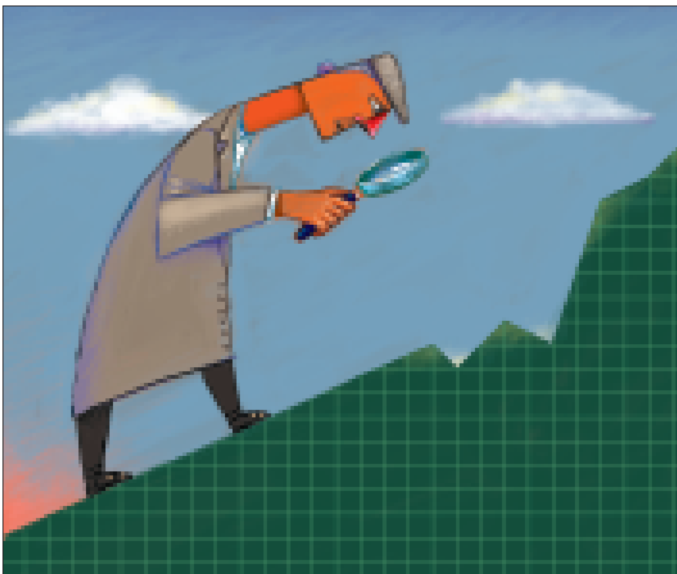
WHAT EVERY INVESTOR SHOULD KNOW

How to Evaluate Investment Portfolio Performance

Portfolio performance is more complicated than simply looking at "how much I started with and what do I have now." You should put portfolio performance in context relative to investment goals, risk tolerance, and the investment climate for the assets invested. This is a guideline on how investors can measure their investment successes.

Goals Understanding why you are investing is the first step in structuring a portfolio, as well as in establishing a framework for viewing portfolio performance. There are a few questions investors need to ask themselves and review with their advisors before starting to invest. Specifically, *What are my investment objectives? What is this money for? What kind of risk am I willing to take? What is my time horizon?* It is important that you work closely with your advisor so you both have a clear understanding of your specific needs and goals.

Risk Understanding risk is an integral factor in understanding portfolio performance. You can view risk as portfolio volatility, as the risk of not achieving your goals, or as the risk of permanent capital loss. When you are assessing risk, questions to ask yourself include: *How much volatility am I willing to accept? What are the consequences if I do not achieve my investment objectives? How large a loss can I sustain? Do I want to use leverage?*



Risk and returns are *generally* related. Over the long term, increasing your risk typically leads to higher expected returns, while lowering your risk leads to lower expected returns. However, this is not always so. Under some circumstances, which may occur for an extended period of time, higher levels of risk may lead to lower returns, and vice versa.

Goals and risk tolerance should be the basis for establishing investment guidelines for your portfolio. These guidelines will enable your advisor to structure your portfolio and provide you with a framework that allows you to review and understand your investment performance.

Investment Climate Not all asset classes, or segments within asset classes, perform in line with each other. Investment professionals use this lack of correlation to lower volatility in an overall portfolio — a fact you should keep in mind when you are evaluating investment performance. For example, if you hire an investment advisor to invest in small capitalization stocks, it is possible that the stocks will perform very differently from the market in general and from other market segments. Because of the potentially low correlation of returns, it is unfair to judge an advisor's performance relative to anything other than his or her own peers or the market environment. It should also be noted that past performance does not necessarily indicate future results.

Relative Returns While the absolute return of a portfolio is important, investors must also look at portfolio performance on a relative basis. To do this, compare your results to a relevant market index as well as to a peer group. A peer group is a group of managers who invest with a similar style and who have similar objectives. For example, if you invest with a large capitalization growth equity manager, compare his or her returns with similar managers as opposed to, say, a group of domestic high-yield managers. At the outset of the investment relationship, you and your advisor should agree upon the peer group and the index (for example, the Standard and Poor's 500) that best reflect the goals of

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the account. Use these as a baseline to determine how well you are doing on a relative basis.

To provide an accurate assessment of performance, take the overall investment climate for the specific asset class into consideration when looking at portfolio returns.

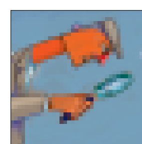
GIPS Standards An important aspect of evaluating an investment advisor's performance is determining whether the advisor complies with the industry's best practices in presenting return history. To promote consistency of performance reporting among advisors, the CFA Centre for Financial Market Integrity, the advocacy and research arm of CFA Institute, has developed the the Global Investment Performance Standards (GIPS®). The GIPS Standards represent the CFA Centre's commitment to establishing one broadly accepted standard for calculating and presenting investment performance history. These guidelines are ethical standards that promote uniformity in reporting investment performance. The standards allow investors to directly compare the performance of different investment advisors, helping to foster an environment of credibility and trust in the investment industry.

The standards require advisors to group their discretionary portfolios by strategy into "composites" and then calculate composite return. Advisors thus calculate the return of ***all*** the portfolios managed to the same strategy or objective, not just one or two "representative" accounts. Managers cannot include in their composites model portfolios or simulated performance that is generated by applying investment strategies to historical information. The standards do require that advisors maintain even terminated accounts in their historical composite return so that generally poorer performing accounts are not dropped from an advisor's return history. The standards also call for advisors to use a consistent return calculation (time weighted rate of return) when calculating composite returns.

Once an advisor has created the composites and calculated calculated the composite returns, these numbers must be shown in a presentation that includes standard disclosures and a consistent presentation format. Disclosures include five years of annual history, the number of portfolios and amount of assets in each composite, and a benchmark for the strategy. These required disclosures ensure that investors receive the critical information on an advisor's performance in a consistent manner. Investors can easily compare the true historical success of an advisor in following a particular strategy if the advisor complies with GIPS.

To find more information on the GIPS Standards, visit the www.cfainstitute.org/cfacentre/ips/.

Qualitative Issues In addition to understanding performance issues, a good working relationship with your advisor is invaluable. At the outset of your relationship, establish the frequency of meetings for reviewing your portfolio as well as a schedule for receiving written material. Your advisor should be willing to take the time to review your goals, your risk tolerance, and explain how you have done on both a relative and an absolute basis. He or she ought to be willing to educate you on the overall structure of your portfolio as well as on general market conditions.



Conclusion To fully understand investment portfolio performance, investors need to work closely with their advisors to establish investment goals and risk tolerance levels. Look at returns on an absolute and relative basis, and consider the investment climate for the specific asset class. In addition to performance, take the entire working relationship with your investment advisor into account when looking for a successful investment program. ■

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