



## How to Think about Investment Returns

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*This introductory article is intended for the educated layman. It was written as part of a continuing series of essays on a variety of investment topics.*

I was reading an instruction book for backpackers a few years ago. The author emphasized the importance of carrying a light load, which makes sense, but I was brought up short by his discussion of how to choose a magnetic compass. He referred to one model that had a number of features and weighed one ounce. Then he described another, simpler model that weighed only 0.8 ounces. "This is just 0.2 ounce lighter," he wrote, "but that's still a 20-percent weight saving."

This is completely backwards! He should have written, "That may be a saving of 20 percent in weight, but it's a difference of only 0.2 ounces." A shaggy backpacker might lighten his load the same amount by just getting a haircut.

A consideration of why the original statement is wrong provides a lesson in how to think about investment returns.

A backpacker carries weight, not percentages on his back. An investment produces money or increased value, not percentages. We use percentages to express relative values. An investment that has a return of 20% is one fifth larger than its original value. If the original portfolio was worth \$1,000,000, then most people would agree that the increase of 20%, or \$200,000, was real money. In contrast, if that original portfolio was worth \$1, the added 20 cents wouldn't make even the poorest citizen of the United States feel much better off.

**This is the third article in this series intended for the educated layman. The other two installments were:**

[How to Think about Investing](#)  
[How to Think about investment Risk](#)



A backpack is a kind of portfolio, a collection of utilities that a hiker might need or want during his sojourn in the wilderness. And an investment portfolio, of course, is a collection of varied investment vehicles, like stocks, bonds, mutual funds, money market funds, and so forth. (Like all analogies, this one is imperfect; it begins to break down when you realize that, all else being equal, a backpacker prefers *less* weight, but an investor prefers *more* money.) Now, if the hiker can shave 20% off the weight of every item in the pack and the pack itself, then he's carrying 20% less weight, and that's a substantial improvement in his well-being.

What matters for the investor is the total package, the entire portfolio. A change in one component of the package, considered in isolation, often matters very little, unless it is indicative of something systematic.

So, if my ability to reduce the weight of my compass by 20% were indicative of an ability to reduce the weight of every other component of my backpack by 20%, then I might be grateful for the knowledge that I could save the 0.2 ounces. But, in actuality, my ability to shave 0.2 ounces off the weight of my compass is indicative of nothing.

If what really matters is the value of the portfolio, not the return, why do we talk about returns at all? Because returns allow us to compare changes in investment value along two dimensions: across time, and across different kinds of investment options (which options include not just stocks, bonds, mutual funds, and so forth, but also investment managers and even inflation).

Across time, we compare the series of returns generated by an investment vehicle day after day, month after month, year after year. Most investments fluctuate in value quite a bit, some much more than others, so a single observation of return (for one day, or one month, or one year) tells us little about what is happening and little about what we might expect. The patterns and averages over time, however, can be informative, as long as one bears in mind that no supreme authority guarantees that the future will be like the past.

Across investment vehicles, and across investment managers, we can make comparisons of results in a given period, and over a span of periods, like, say, the last decade. If an investment manager can pick a stock that increases 20% in value in a given span of time, this is of little interest unless it is indicative of her overall ability to pick stocks that increase in value within a period of time, and over multiple periods of time.



Investment managers, professional and amateur alike, delight in talk of their successful investment picks. But what has a man profited, if he gains returns, and he loses net worth? Few, however, can keep this thought at the fore for any length of time; hence the cynical but trustworthy maxim for anyone selling investment advice: talk about your winners.

That is one way to mislead investors about returns, but there are other tricks of the trade. One of the simplest is to confound yield with return, and to boast of the former without regard to the latter. Only in special circumstances are yield and return the same thing, and usually they are not. "Yield" is the income thrown off by an investment vehicle, expressed as a percentage of the price of that investment vehicle. For example, if a stock that is priced at \$50 pays an annual dividend of \$2, then it has a dividend yield of 4% ( $=\$2/\$50$ ). And if—and only if—the stock begins and ends the year at that same price of \$50, the return on the stock for the year will also have been 4%. But what if the stock's price began the year at \$50 and falls to \$40 at the end of the year? In that case, the dividend yield actually went up (because at the end of the year, it takes only \$40 rather than \$50 to generate the \$2 dividend), but the investor in that stock lost a net value of \$8, because of the price decline. The stock in this case had a negative return. In short, yield is only one of two components of the total return, and not even necessarily the most important component. Uncle Sam, you can be sure, is never confused about the two components of return. He taxes income and long-term price increases (capital gains) at separate and distinct rates (though, since the Economic Growth and Tax Relief Reconciliation Act of 2001, for stocks these are usually and for the time being the same rate). This means that, if an investment has both yield and a price return, taxes lower your total return when the pre-tax return is positive, and they may also lower your return *even when* the pre-tax return is negative, because yield by itself is always positive. This is one reason (among several) that an investment manager should be dedicated to achieving good after-tax returns for a taxable portfolio, not pre-tax returns.

Investment managers have not been above taking advantage of investors' confusion of yield with return. Nearly twenty years ago, a well-known mutual fund company was promoting a government bond fund (normally considered a safe investment) with "enhanced" yield. The only way to enhance the yield, though, was through the execution of a strategy that the manager believed to be "safe," but which was not. The manager was making a bet on interest rates that turned out to be very wrong. In order to keep the investors happy, the fund continued to pay out its high "yield", but these payments weren't yield; they were actually payouts of the principal of the fund. Returns were negative.



Returns can be slippery. They are essential as indicators of past performance and for framing expectations for the future, but they must be interpreted with care. In the end, what matters for your well-being is not the return you realized, but the value of your portfolio.

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