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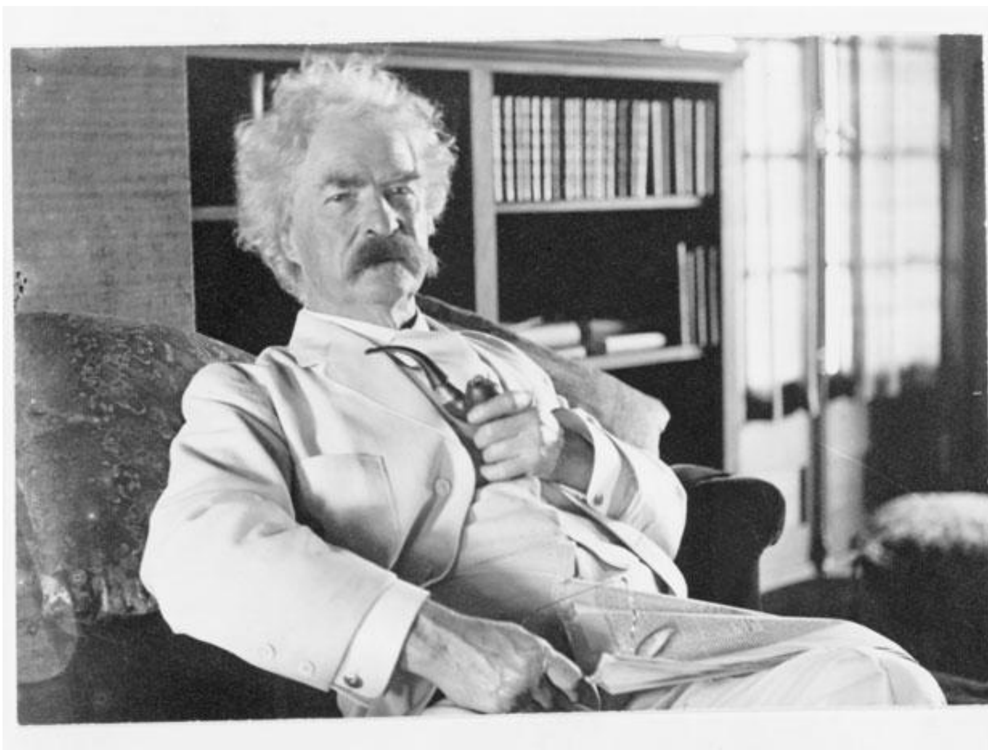
Lies, damned lies and returns

Michael Nairne, Serious Money



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U.S. author and journalist Mark Twain popularized the saying about "lies, damned lies and statistics."

The saying popularized by Mark Twain, "lies, damned lies and statistics," might spring to mind when investors grapple with the reams of return numbers spewed out by funds, managers and the financial press. It's easy to understand why investors can be confused.

First, the industry standard — which is a time-weighted rate of return — is designed to measure a portfolio's compound rate of growth and is not sensitive to the timing of investor contributions or

withdrawals. Although this allows performance comparisons between the managers, their peers and benchmarks, it also means that the actual returns earned by individual investors can vary, sometimes significantly, from a fund's or manager's reported returns. For example, an investor who routinely invests money in equity funds at market highs and then pulls back during lows will have a personal rate of return less than that reported by the funds.

Unfortunately, the propensity to "buy high and sell low" means investors, as a group, earn returns well below those of their fund investments. Morningstar found that from 2000 to 2009, U.S. mutual fund investors earned returns 1.5% per annum less than the funds themselves. Investors in highly volatile funds that are often subject to performance chasing typically have even greater shortfalls. So if you're unhappy with your performance, your own behaviour might be a factor.

Second, there is often a difference between the historic returns profiled by mutual funds and those of private investment managers. Fund returns are typically portrayed net of fees while the returns of private investment managers are normally quoted gross of fees. This is because the percentage fee charged by private managers varies with the dollar amount invested so there is no single percentage fee to net against returns. If you are comparing funds to private managers, you likely will need to adjust accordingly.

Even when you have a complete, net of fee return history, you still don't have a full picture. Funds and private investment managers report their returns before tax. No adjustment is made for returns that are fully taxed (such as interest) and those that are more tax efficient (such as capital gains, eligible dividends and unrealized capital appreciation).

Affluent individuals with non-registered investments need to know the tax efficiency of their funds and managers. Studies in Canada and the United States have found that the performance ranking of many managers will change when comparisons are made post-tax as opposed to pre-tax. Taxes in many instances can even exceed fees.

Another problem with returns is that they may not reflect the risks to which an investor is exposed. Returns for certain assets, countries, or sectors can be mouth-watering for years in a row before the inevitable painful plunge. Think of Japanese stocks in the '80s, large-cap growth stocks in the '90s and U.S. houses in the past decade.

Even when the risks are known, investors must determine whether adding a particular asset class or strategy to their portfolios will enhance its diversification. Certain strategies that are highly volatile when viewed in isolation can actually improve the risk-adjusted return potential of a portfolio. International small-cap stocks and managed futures are examples.

Finally, focusing excessively on historic returns is also a mistake. Academic research indicates that the price movement of individual stocks is largely unpredictable and that active manager performance is also not persistent.

Aaron Levenstein quipped, "Statistics are like bikinis. What they reveal is suggestive, but what they conceal is vital." While return statistics do not lie, you have to dig behind them to get a complete understanding of the impact of contribution and withdrawal timing as well as the fees, taxes, risks and diversification effect associated with the returns.

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