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Investment Corner

Strategies, Secrets and Common \$ense

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The truth about returns

You cannot judge a book by its cover and you cannot always judge an investment by its advertised return. Many investments including mutual funds provide annual return data. Many investors use this information to determine "average annual returns". On the surface, this approach seems reasonable, however, an average return over a period of years only appears to be a fair method of comparing investments. Take the performance numbers in Table A:

TABLE A

Investor I		Investor II	
Year	Return	Year	Return
1	18%	1	7%
2	(12%)	2	1%
3	23%	3	12%
4	7%	4	4%
5	(9%)	5	(1%)
6	6%	6	8%
7	17%	7	12%
8	22%	8	8%
9	(18%)	9	2%
10	3%	10	4%
Total	57%	Total	57%
Average Annual Return	5.7%	Average Annual Return	5.7%

Both investors received the same average return over the 10-year period. Investor I enjoyed four excellent return years of 18%, 23%, 17%, and 22%, but also endured three down years of 12%, 9%, and 18%. Investor II, on the other hand, had fairly bland returns with the best return of only 12% and the worst return at (1%). As you can see, there are several ways to achieve the same average rate of return.

How does the average return equate to actual cash performance? This is clearly the most important measurement. As investors, we want to know the "bottom line." How much is my investment worth?

In order to determine asset growth, we must complete a different performance measurement – this measurement is "average total return". How much would \$1,000 be worth in each of these portfolios at the end of the 10-year time frame?

TABLE B

Investor I			Investor II		
Year	Return	\$ Value	Year	Return	\$ Value
1	18%	\$ 1,180.00	1	7%	\$ 1,070.00
2	(12%)	\$ 1,038.40	2	1%	\$ 1,080.70
3	23%	\$ 1,277.23	3	12%	\$ 1,210.38
4	7%	\$ 1,366.64	4	4%	\$ 1,258.80
5	(9%)	\$ 1,243.64	5	(1%)	\$ 1,246.21
6	6%	\$ 1,318.26	6	8%	\$ 1,345.91
7	17%	\$ 1,542.36	7	12%	\$ 1,507.42
8	22%	\$ 1,881.68	8	8%	\$ 1,628.01
9	(18%)	\$ 1,542.98	9	2%	\$ 1,660.57
10	3%	\$ 1,589.27	10	4%	\$ 1,726.99
Total	57%		Total	57%	
Average Total Return	4.64%		Average Total Return	5.48%	

As you can see in Table B, the average total returns differ significantly from the average annual returns. What once was equal is now far from equal. Why does this happen? Investor I and Investor II have the same average return and Investor I has several really excellent performance years. The secret is in the loss column. Avoiding volatile performance, especially large declines, is at the heart of long-term investment success. You cannot always avoid market declines, but if you are able to minimize the losses in bad years, the good years will be spent advancing your financial worth instead of catching up from past mistakes.

A simple illustration demonstrates the impact of volatility on performance. If you experience a 50% portfolio decline in year one, what return do you have to achieve to break even by the end of year two? That is right, 100%. In this extreme example, your average annual return would be 25%, yet you would have earned nothing over two years so your average return would be "0."

Conclusion: There are many ways to measure investment performance and some measurements deliver more fluff than they do substance. Portfolio management involves blending the right asset classes to deliver portfolio protection along with asset growth. In fact, sometimes the best long-term-growth strategy can be preserving principle. Just remember that making money is important, and protecting your money is essential.

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