When You're Serious…

by Bradley R. Newman, CFP®

Compared To What?

As you look at your investment portfolio, are you asking the common questions that are on most people's minds: Are my returns good? Am I taking too much risk? Am I paying too much in fees? In each case, the appropriate answer is actually another question: Compared to what?

All of these are good questions, but none of these questions can be appropriately answered without going through a methodical benchmarking process. Without providing an appropriate point of comparison, the answers to these questions, and the ultimate decisions you will make, will occur in a vacuum instead of being based on an empirical process.

Are My Returns Good?

Compared to what? Would you consider a 30% return for 2013 to be a good return, an average return or a poor return? In absolute terms that seems like a good return; after all, that is almost what the S&P 500 returned last year.

Let's narrow our focus to mutual funds that are found in the large cap growth category. In 2013 there were almost 1,800 funds in that category and a 30% return ranked in the bottom quartile of all large cap growth mutual funds. As a point of comparison, the median performer of the top quartile of large cap growth funds returned almost 40% last year; a 10% advantage over what, at first glance, may have seemed like a good return.

Am I Taking Too Much Risk?

Compared to what? The casual observer might say that all 10% returns are equal, but they would be wrong. The end result is only half the story, a critical component is factoring in the amount of risk assumed to generate the 10% return.

Risk, or more aptly volatility, can readily be quantified by a metric called beta, which measures the inherent level of risk relative to a constant benchmark; for example, the S&P 500. If you assumed twice the amount of risk to generate the same return that the S&P 500 produced last year, your return is not equal – you underperformed by almost 30% given the risk that you assumed.

Am I Paying Too Much in Fees?

Compared to what? For most, the visceral instinct is to choose the investment with the lowest level of fees, or at least the lowest level of fees that they can identify. A question to continually ask yourself is "Is there any value to be had for choosing an investment with a higher fee?".

As an example, let's compare the fees to the net returns of two large cap growth funds; one is a Vanguard fund and the other a Fidelity fund. Both funds have the same investment mandate as large cap growth funds, but the Vanguard expense ratio is 0.52% versus the 0.74% expense ratio of the Fidelity fund; a 0.22% differential. On the surface it would appear that the less expensive Vanguard fund would be the best choice; however, choosing to own the Vanguard fund in 2013 would have cost you 14.2%. While the Vanguard fund is less expensive, it gained 32.3% last year while the Fidelity fund gained 46.5%; the net benefit to your bottom line would have been notable by choosing the more expensive option.

Tough Questions…

Can you, or your advisor, confidently answer each of these questions or the myriad of other questions that you should be asking on a regular basis? If not, its likely time for a second opinion from an advisor who can provide an independent, arm's length, empirical analysis for you.

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