

# Sort Through an Investment's Return

By Jean Keener

**E**ver opened up your 401(k) statement and found yourself wondering, “Is this good?” Or seen the sales commissions being charged each time you invest in your mutual fund and thought, “How are these affecting my retirement savings?” But as you start thinking about all the percentages, ratios, and math involved in answering these questions, your eyes glaze over, and suddenly tomorrow sounds like a much better time to start answering these questions.

Well, in reality, you deal with return on investment daily in your life. It can be a question of how much effort you'd have to invest to lose 10 pounds. Or whether it's worth the time required to cut carrots and put them in small bags for school lunches to save the money on preassembled snack packs. You make these decisions constantly in a split second based on your priorities, knowledge, and resources of time, money, or energy.

Assessing financial return on investment really isn't much different. Figuring out your returns takes just a couple of minutes. This can mean a better retirement, a cooler vacation, or more money to spend on the things you really care about.

## Calculate Your Return

The *return* is how much money you made or lost on an investment. You look at how much you invested and the total amount it's worth now. The difference in these amounts is your *absolute return* — either positive or negative.

### *Holding period return*

*Holding period return* shows you the absolute return over the entire time you owned the investment, whether that's three months, a year, ten years, or some other time period. Here's how to calculate the holding period return:

Total worth of investment now – money invested = holding period return



With the holding-period-return formula, don't forget any dividends or other income received from your investment. If you reinvested the income, it's automatically included. If you didn't reinvest, you need to add the income to what your investment is worth now to calculate an accurate return.

After you figure out the dollar amount you made or lost (hopefully made!), you can convert it to a percentage. Percentages allow you to compare different investments to each other regardless of the dollar amount of money invested. Here's how to calculate your percentage return:

Holding period return ÷ money invested × 100 = percentage return

## Annualized return

The rubber really meets the road with annualized returns. If a couple buys a house for \$100,000 and sells it ten years later for \$130,000, they may think they earned a really great return. They made \$30,000, or 30 percent, according to the formula in the preceding section. But think about what that actually equates to each year.

Calculating annualized returns requires more math than holding period return because of compound interest. Each year, your investment's increase in value is based not only on the original investment amount but also on all the interest or increase in value gained in earlier years. Financial planners use software or a financial calculator to calculate annualized returns; no one does this manually. For the \$100,000 house that sees a 30-percent holding period return over ten years, the annualized return comes out to 2.66 percent.



You can eyeball annualized return with this shortcut:

Percentage return (of holding period) ÷ number of years = ballpark annualized return

With the house example, the annualized return comes out to 3 percent when you use the shortcut method. (Just remember that this shortcut isn't exact.)

You can also use online calculators to get exact annualized return figures. If an online calculator asks for the *present value*, enter the value of the investment at the beginning. *Future value* is the value of the investment at the end. Some good online calculators are available at [www.moneychimp.com](http://www.moneychimp.com),

bankrate.com, and finance.yahoo.com (do a search for “compound interest calculator” for other options).



Don't forget the effect of expenses when calculating your returns. Here are the most common expenses:

- ✓ **Real estate:** Take into account commissions, property taxes, and interest on your mortgage, among other expenses. If you're calculating returns on your primary residence, also take into account that you need a place to live, so you would've been paying rent if you hadn't been paying your mortgage.
- ✓ **Mutual funds, stocks, or bonds:** Include any commissions or management fees as part the initial cost of your investment. If you're not sure whether you're paying commissions, you probably are. Ask for no-load funds if you want to avoid commissions, and be sure to understand how your advisor is being compensated.

## *Identify Good versus Bad Returns*

After you calculate your annualized return, you're ready to determine whether your results are up to par. Three basic factors show you whether your returns are doing their job. The importance of each depends on your personal circumstances.

### *Achieving your goals*

The first question you need to ask is whether this investment is returning enough to achieve your goals (see Strategy #13 for info on setting financial goals). When you set a goal to retire in 15 years, you make several assumptions about how much money you'll be saving and what kind of return you'll be earning on your savings. In financial jargon, this is your *required rate of return*. A required rate of return varies by individual, depending on the following:

- ✓ The length of time the money will be invested
- ✓ Your tolerance for risk
- ✓ Other options available to you as investment vehicles

If your investment is meeting your required rate of return, great! If not, you can adjust your goals, seek a better-performing investment, or take on more risk.

## *Beating the benchmark*

How does your investment's return compare to its peers? In some years, a 2-percent return for a particular mutual fund is pretty good. In other years, a 2-percent return for the same mutual fund is terrible. It all depends on what other comparable funds did that year.



To accurately compare an investment to its peers, determine what the relevant benchmark is. You can usually find information on the benchmark and the average performance of similar funds on your brokerage's Web site. Here's how to define peers of various investments:

- ✓ **Stocks:** Compare with other companies of similar size in the same industry.
- ✓ **Bonds:** Compare with other bonds of similar maturity dates and credit ratings.
- ✓ **Real estate:** Compare real estate appreciation or depreciation in similar neighborhoods in the same or other markets. Sites such as [www.zillow.com](http://www.zillow.com) or [www.realtytimes.com](http://www.realtytimes.com) are good sources for market comparisons.
- ✓ **Mutual funds:** Three industry standard benchmarks are based on the size of company a mutual fund invests in:
  - **Large cap:** S&P 500
  - **Mid cap:** S&P 400
  - **Small cap:** Russell 2000



Look for choices that have consistently performed at or above their benchmark, but beware — you shouldn't jump to a fund just because it's had a really terrific year and wildly outperforms its comparison fund. You also shouldn't automatically dump a fund because of one bad quarter or year. A lot of investors chase returns, but when you do, you have a good chance of buying high and selling low rather than the other way around.