"I guess I should warn you, if I turn out to be particularly clear, you've probably misunderstood what I've said."

Alan Greenspan

2013 was an excellent year if you invested in stocks. U.S. equity markets led the way, advancing over 30% for the year and achieving record highs for the S&P 500 and the Dow Jones Industrials. Developed foreign equity markets also fared well with most delivering double-digit returns. The lagging asset classes for the year, with flat to negative returns, were emerging markets equities, bonds and commodities. When analyzing results after a year like 2013, proper evaluation is not exclusively about tracking percentage gains. Comparing portfolios against long-term goals, the impact of inflation and specific market indices can provide investors with greater insight into their true portfolio progress.

While the last few years have been strong for many financial markets, most of us have lived through both bull and bear markets. In order to assess performance across the variety of market environments we must consider the following questions: What is an appropriate comparison of performance? How do you know how well your portfolio, or manager, is doing? Which are the most appropriate performance comparisons? What is the longer-term impact of performance on your investment goals and objectives?

Three common investment performance comparisons are absolute return, real return and relative return. These measures enable investors to compare results against planning objectives, the impact of inflation, and the relative return of your investment strategies – and investment manager. Each of these performance measures provides an investor with useful information about portfolio results. We explore the benefits and drawbacks of these different comparison methods below.

1. Absolute Return Comparison

Benefits	• Easy to understand and calculate return • Helpful when used for planning purposes to project future portfolio value
Drawbacks	• Does not account for risk assumed in an investment portfolio • May not provide a complete picture when comparing results of different strategies or managers

Absolute return is the basic return generated by the portfolio. If you started the year with $100,000 and ended with $115,000, the absolute return is 15%. An absolute return is the easiest to compute and understand: Was the return positive or negative and over what period of time? For planning purposes, absolute returns are used to forecast the value of a portfolio and for matching cash flows needed from a portfolio. For example, in planning for retirement an investor might assume an absolute return of 7% on their retirement savings. Applying a 7% rate of return enables you to calculate the value of retirement savings in the year of planned retirement. While, it is highly unlikely the return will be 7% each year, using a single absolute return number allows you to calculate a future value. Most investors (and all managers) understand there is risk inherent in virtually all investment securities and strategies. Unless your portfolio is very defensively invested there will be market periods where the absolute return is negative.

2. Real Return Comparison

Benefits	• Provides for comparison against effect of inflation on performance • Helpful when addressing the long term negative effect of inflation on investment goals
Drawbacks	• Does not account for performance relative to the investment strategy • Does not account for risk assumed in an investment portfolio

Real return adjusts absolute return to account for the impact of inflation. Typically this is accomplished by calculating the absolute return, less a recognized measure of inflation such as the Consumer Price Index. For example, if your portfolio returns 7% and the CPI is 3%, the real rate of return is +4%. As an investor, it's important to avoid the loss of purchasing power that accompanies inflation. If you invest $100,000 for 10 years and inflation averages 2% you will need $124,000 at period end to maintain your purchasing power. If you have more than $124,000 at the end of 10 years, your real rate of return is positive - less than $124,000, your real rate of return is negative. Anyone concerned with protecting the purchasing power of a portfolio should strive for a real rate of return over time that exceeds inflation.

3. Relative Return Comparison

Benefits	• Provides a specific comparison for an investment strategy • Helpful when evaluating the performance of an investment manager
Drawbacks	• Requires a level of precision when selecting comparison benchmarks • If benchmarks are not appropriate the comparisons can be misleading

Relative return is the comparison of results against an appropriate index or benchmark. Relative return is the most common, but most nuanced return measure, used by investment managers. When properly selected, the relative return benchmark allows for comparisons in both positive and negative return markets. For example, if the U.S. equity portion of your portfolio returned 8% and the S&P 500 returned 7% your relative return is +1%. While this comparison has significant value to both investors and managers it requires some precision when applied to a portfolio. U.S. large cap stocks should be compared to a U.S. large cap index, bond portfolios to a bond index and so on. When looking at a balanced portfolio the components should be compared separately while the overall portfolio can be compared to a blended benchmark. Relative return comparisons for diversified portfolios can be complicated and may allow for broad interpretation of performance, both good and bad.

The performance measures discussed above are the most common. There are other performance measures that can be helpful in certain situations including after-tax returns and risk-adjusted returns.

At Aureus we provide investment performance reports as part of our quarterly reporting to clients. It is important to us that you understand the performance of your account and the impact on your long term financial objectives. It is also important that you have an opportunity to ask questions about the results and that we provide clear answers.