MISSION WEALTH®

Your goals. Our mission.

Ensuring your portfolio matches your risk v. return needs is crucial to smart investing

July 31, 2023
By Gary Brooks, CFP®, CSRIC™

Entering August, broad market indexes for U.S. and international stocks have reached bull market territory with gains above 20 percent since their bottom last October. Globally, bond markets have returned to positive results after their unusually deep declines for much of 2022.

While recent positive returns are welcomed, there is deeper context to understand when determining how well your individual investments or your broad portfolio strategy are performing.

Beyond a simple positive or negative view of returns, investors should evaluate how their investments are performing to understand whether the investments are competitive with their peers and aligned with your personal financial goals.

Evaluating investment performance can be difficult, however. Different people in different circumstances may have varied definitions of success. Evaluating performance is all relative: to your own expectations, to benchmark indexes of similar investments, and to the amount of risk taken.

Risk and return are two sides of the same coin that need to be understood in relation to your investment returns. It can be helpful to understand how much compensation you are receiving for the given level of risk you are taking. In some cases, high returns might come with high exposure to potential declines. Alternatively, investments with moderate positive returns may have meaningfully less exposure to down-market events and technically be less-risky options that provide a higher level of compensation for the level of risk taken.

Beyond understanding dollar or percentage gains and losses over any period, one helpful data point available at Morningstar.com is a rating of risk and return for mutual funds and exchange-traded funds relative to their category peers. Some funds rated high for risk, might also generate high returns to compensate for the risk. What you should be wary of are investments that have higher risk ratings than return ratings. A fund with an above-average risk rating compared to its peers and a below-average return rating may not be worth owning. Counter-intuitively, there are billions of dollars invested in funds that, based on these ratings, have the risk/return equation backward in their performance history.

When evaluating returns, there are index benchmarks that represent about every way you could possibly slice markets, U.S. vs. international, large companies vs. small, growth stocks compared to value stocks, corporate bonds vs. government bonds and many other distinctions. When comparing your investments to an index, it is important to make sure that the comparison is relevant. For instance, you shouldn't compare a growth-stock heavy mutual fund or exchange-traded fund to a broad market index like the S&P 500 which also holds value stocks. The lead for growth stocks over the past several months has provided a large edge over broad-market indexes. If you were to retrace the calendar a year to mid-2022, you would see nearly the reverse with strong market leadership from value stocks. Notably, you should also refrain from comparing your investment returns to the most often-cited index in the media. The Dow Jones Industrial Average is comprised of just 30 U.S. stocks making it of little use as a measure of performance for most people's investments.

Index comparisons are informative, but don't make them your only measure of investment success. The index doesn't have management fees or transaction costs that apply to your investments. Indexes also don't have any cash flows in the middle of the reporting period which can significantly influence the return of a personal portfolio. Small differences in the buy and sell dates of your transactions and cash flows into or out of your accounts can make large differences in the total return experience compared to an index.

When you review your investment performance compared to any type of benchmark, keep in mind that short-term performance is noisy. The smaller the sample size of the outcome you are evaluating, the less weight you should place on the performance. A year-to-date return doesn't provide as much information as a 3-, 5- or 10-year record for an investment.

While you or your investment advisor should understand how to evaluate investment performance, the ultimate measure of success is whether it is supporting your long-term financial plan. If you have confidence that your investment strategy is based on a robust methodology that can be expected to make your portfolio resilient across multiple investment cycles and changing conditions, that may be the most important step toward successful investing. When you shift strategy to navigate through changing conditions, responding to short-term noise, you put stress on your portfolio to be in the right place at the right time. Trying to find an edge this way is typically counter-productive and possibly damaging to the probability of success of your long-term financial plan.

Gary Brooks is a certified financial planner and a partner at Mission Wealth Management in Gig Harbor.