

UNDERSTANDING INVESTMENT PERFORMANCE

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This is one of a series of Research Briefs created by Brinton Eaton to keep our clients informed about key developments — in financial planning, tax strategy, and investment management — that we research and implement as appropriate on your behalf.

Each quarter, in your investment performance exhibit, we give you an update on how your portfolio has fared during the preceding three months, and for the year to date. In the cover letter accompanying that exhibit, we provide broad market benchmark returns against which you can compare your results. The purpose of this *Brief* is to clarify some important points about this comparison, since an incomplete understanding has led some of our clients to seriously under appreciate how well their portfolios are truly performing.

The Basics

First, the percentage returns for each quarter are not annual returns, nor are they annualized. They are simply the returns over a three-month period, and should not be compared to expected annual returns, which would be much higher. Likewise, the year-to-date returns are not annual either, except, of course, for the ones that are shown with the fourth quarter results.

Second, the benchmark index returns we provide are calculated on a “total return” basis. This means that any income (e.g., interest or dividends) generated by the investments that make up the index are assumed to be immediately reinvested back into the index. This results in a benchmark return higher than what you typically see quoted in the press. For example, in 2006, the S&P 500 Stock Index increased 13.6%, from 1248.29 to 1418.30. But on a total return basis, the increase was 15.8% — dividends on the stocks that make up the index account for the difference. All the market benchmark indexes we provide you — and encourage you to compare your own returns against — are calculated on this higher, total return, basis. We believe this provides the most appropriate and fair context within which to view your results.

Tax Accounting vs. Economic Reality

Also contained in your package is a quarter-end portfolio statement that shows, among other things, the current market value of each of your holdings, the associated “cost basis”, and the difference between these two values, which is the “unrealized gain”. Some investors are tempted to use the unrealized gain figure as a proxy for investment performance. A straightforward example will show why this can be drastically wrong.

Let’s assume that on January 1, 2004, we purchased for you \$100,000 worth of the Oppenheimer Commodity Strategy Total Return Fund (a commodities index fund that we have used — trading symbol QRAAX). Let’s further assume, to keep the scenario simple, that there are no other holdings in your portfolio, and that no subsequent trades, deposits, or withdrawals were made. Three years later, on December 31, 2006, you would find that the market value of

your QRAAX holding had risen to \$130,075 — a three-year total return of 30%. Your investment performance exhibits would reflect this growth, quarter by quarter. What would the unrealized gain on your December 31, 2006 portfolio statement show? It would display a *loss* of \$21,208!

Which of these results is real? And why the discrepancy?

The economic reality is unambiguous. You invested \$100,000 and three years later you had \$130,075 to spend. That \$30,075 gain is as real as it gets. [*Warning: The balance of this paragraph is a bit technical. It can be skipped without losing the main thread of the discussion.*] Now, during the three-year period, QRAAX, in addition to its daily price fluctuations, generated \$51,283 of dividends and capital gains distributions. As is the case with all mutual funds that we use, these distributions were automatically reinvested back into QRAAX within your account. Under tax accounting, these reinvested distributions are added to the cost basis (we'll see why in a moment). So, by December 31, 2006, while the market value (which, of course, includes these reinvestments) had grown to \$130,075, the cost basis had grown to \$151,283, resulting in an "unrealized loss" of \$21,208. The paradox occurs because the tax authorities do not wish to tax you twice on the same income. Your dividend and capital gain distributions were subject to tax in the years they were made. When it comes time to sell your QRAAX holding (let's say you sold it all on January 1, 2007), these distributions are not subject to tax a second time. This is accomplished by increasing the cost basis one dollar for every dollar of reinvested distributions.

What is the lesson in all of this? **If you want to know how well your investments are doing, use the investment performance exhibit.** (And if you would like to know how you have done over multiple years, please contact us. We would be happy to compile your long-term results.) The cost basis, unrealized gain, and realized gain information shown elsewhere in your quarterly package is relevant only to the tax man.

More on Those Benchmark Comparisons

Sometimes questions arise about the treatment of fees, expenses, and taxes in investment performance comparisons. We attempt to provide a straight apples-to-apples comparison of your returns against the benchmarks, and where we cannot do so, we "stack the deck" in favor of the benchmark. Specifically:

	Client Returns	Benchmark Returns
Transaction fees	Net	Gross
Fund management fees	Net	Gross
Brinton Eaton management fees	Gross	Gross
Income taxes	Gross	Gross

This bias in favor of the benchmark is reflected in several other aspects of the comparison. For example:

- We generally do not invest in lower-quality bonds; these have higher yields, as a rule, and are included in the index. We have not adjusted the benchmark comparison for this.
- When you require unexpected or unusually large withdrawals, we attempt to raise the necessary cash in a tax-efficient manner. This may entail sacrificing pre-tax gains in the

short term in order to obtain better after-tax gains in the longer term. In other words, we are always focused on maximizing your after-tax wealth, even though your quarterly investment performance figures (which are pre-tax) might be higher if we did otherwise. We have not adjusted the benchmark comparison for this.

- Note that investors cannot invest in the benchmarks.
 - There are investment vehicles (e.g., mutual funds) that attempt to track the benchmarks, but these carry fees/expenses. We have not adjusted the benchmark comparison for this.
 - Additionally, studies have shown that the average investor in these funds gets about ½ the return of the fund itself (because individual investors generally lack sufficient discipline, they get in and out at the wrong times). We have not adjusted the benchmark comparison for this, nor for the fees involved should the investor hire a professional advisor to address this problem.

So, when your investment performance compares favorably to your benchmark, know that it actually is more superior than the numbers imply. And please do not hesitate to contact us if you have any questions about your investment performance.

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