

Evaluating Investment Performance

Judging the performance of your investment manager is different than judging the performance of other service professionals. With your lawyer, either he did or did not provide a good solution to a problem, won a case or lost it. Your doctor either fixed your broken leg or you limp for the duration. Your CPA either got the right information and filed legal and tax-effective returns or the IRS will get you. The difference between these disciplines and investment management is that performance for investors is quoted in the paper every day, by the minute/second on TV and web sites. Are short-term changes in market price the right metric on which to focus?

There are matters beyond investment performance that are important to clients and they should be mentioned. People want firms that can be trusted and have experienced, well-trained investment professionals with no conflicts of interest. Clients need safe custody of their assets and understandable statements including accurate tax records. They need competent administrative service and good communication. In sum, an important part of performance is in the details, and most importantly, having access to a competent “trusted advisor.”

In addition to the above, investment performance over time is a key ingredient to client satisfaction. How should it be measured? Two ways are common, absolute and relative returns. Individual investors usually think in absolutes—was the market value of my account up or down last year? Institutional investors think more in relatives—how did the portfolio perform relative to market benchmarks or relative to peers? Most investors understand that one year results are little more than statistical noise and focus should instead be on results over the longer term.

Another important factor to take into consideration is risk. There is little consensus on what constitutes investment risk. Some define it in terms of relative variability compared to the market as a whole. Others would put more emphasis on predictability. Farmers know that periodically, no matter what they do—hail, freezes, floods, or pests will cause losses. The stock market is not dissimilar. Markets are inherently unpredictable, ruled by unruly mobs of irrational investors. Jeremy Siegel, a well-known investment expert, author, and Wharton Business School professor, studied all the big market moves between 1801 and 2001. His conclusion—75% of the time there was no rational explanation for stock market moves up or down. Long term, stocks and farms are good investments, but do not expect smooth sailing in the short term.

Asset allocation (spreading capital among different classes of assets) and diversification are basic tools to mute risk and increase predictability. Most investors want, to varying degrees, some level of “safety.” In an uncertain world, asset allocation and diversification provide this as much as possible. What else is important? The wealth held by most individuals and institutions is there to provide a stream of income now or at some time in the future. For most investors, the most important metric is the stream of income, adjusted for inflation.

A steady and rising stream of income comes from growing corporate earnings and managements that are willing and able to share that growth with shareholders in the form of higher dividends. These two factors, earnings and dividends, are much more stable and predictable than the short-term gyrations in stock prices. They determine stock prices in the long run, but fear and greed usually dominate the short term.

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Investors should judge investment advisors on their ability to construct portfolios with a wide variety of relatively stable earning streams from companies with good liquidity and minimum debt. Focus should be on the income stream produced by the portfolio, the inflation-adjusted growth of that income stream over time, and the possible risks of disruption to the income stream.

A positive corollary to emphasizing the income stream is that the process promotes sound investment practice. In order to provide solid income streams that grow over time, investments must be in successful, profitable, and shareholder-oriented companies. You need a bias towards equities, within your own risk parameters, since only stocks can grow income over time. It promotes a long-term outlook towards stock holdings and reduces panic in bear markets. It helps to avoid the shooting star/torpedo syndrome of the late 1990s.

The following is an account history that puts emphasis on what is important. Note that the “Net Additions” includes withdrawals and that sum is added/subtracted to the “Accumulative Capital” column to provide a running total over time. In simple terms, accumulative capital is the amount the client gave the investment firm to manage.

ACCOUNT HISTORY								
Date	Market Value	Net Additions	Accumulated Capital	Accumulated Appreciation	Annual Income	Yield on Contributed Capital	Asset Mix	
							Cash/Bonds	Stocks
	(1)	(2)	(3)	(1 - 3)	(4)	(4 / 3)		
Starting	2,340,000	2,340,000	2,340,000					
Year 1	2,397,400	10,000	2,350,000	47,400	88,000	3.74%	40%	60%
Year 2	2,584,200	50,000	2,400,000	184,200	83,000	3.46%	39%	61%
Year 3	2,786,200	(20,000)	2,380,000	406,200	82,000	3.45%	50%	50%
Year 4	3,111,000	(70,000)	2,310,000	801,000	108,000	4.68%	45%	55%
Year 5	2,961,600	(100,000)	2,210,000	751,600	80,000	3.62%	39%	61%
Year 6	3,410,000	(60,000)	2,150,000	1,260,000	92,000	4.28%	45%	55%
Year 7	3,625,600	(110,000)	2,040,000	1,585,600	83,000	4.07%	52%	48%
Year 8	3,766,200	(100,000)	1,940,000	1,826,200	96,000	4.95%	57%	43%
Year 9	4,051,400	(120,000)	1,820,000	2,231,400	106,000	5.82%	50%	50%
Year 10	4,303,000	(120,000)	1,700,000	2,603,000	131,000	7.71%	49%	51%

ESTIMATED ANNUALIZED DATA FOR 10 YEARS

1	Annualized Total Return	8.1%
2	Average Annual Income	2.9%
3	Growth in Principal (1 - 2)	5.2%
4	Annual Inflation (CPI)	2.5%
5	Real Growth in Principal	2.7%

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