

Parsing Returns

What's the return? It's perhaps *the* basic question for investors. But the answer comes in different forms, and knowing the differences is essential.

Absolute and Relative Return

Absolute return is the thing itself, the objective of most investors—the amount of payback from an investment. It is typically expressed as a percentage of the invested amount over the course of a year: “It returned 5 percent last year” (the equivalent of \$5 for every \$100 invested). That reports positive absolute return—money receivable from the investment, independent of other factors. **Absolute return** can, of course, be negative, measuring loss from an investment as well as gain.

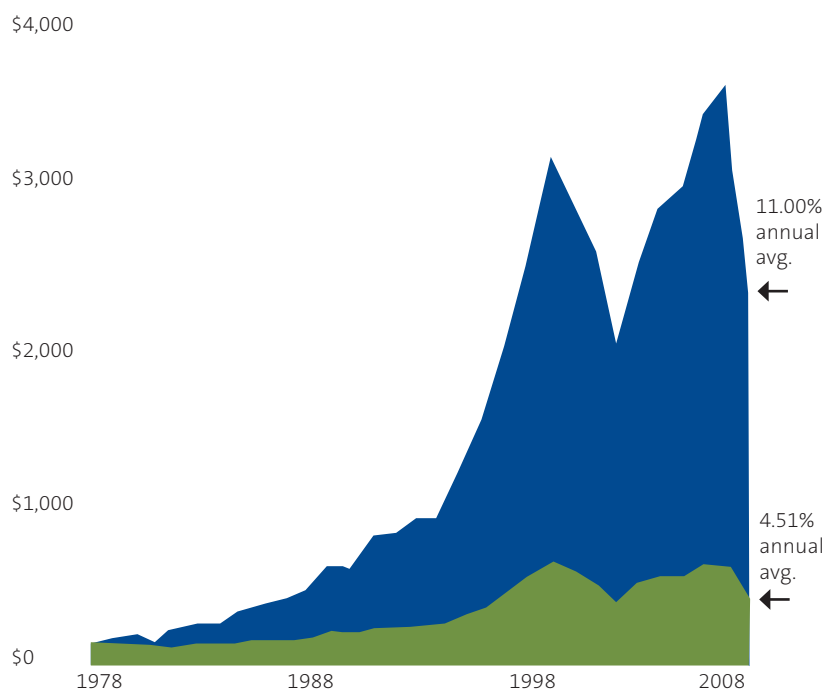
Relative return, on the other hand, measures performance compared to a benchmark such as a market index, a market sector or a class of assets. **Relative return** is therefore a measure of investment management success—but not necessarily investment success. **Relative return** tells whether your small-cap mutual fund, let's say, is beating, matching or lagging the performance

of the small-cap market as a whole (measured by an index such as the Russell 2000 Index). Or how your fund's performance compares to that of other small-cap funds. But **relative return** does not tell you if your small-cap investments are gaining. That's because your fund's **relative return** might show as positive (better than the index, say) even when the value of the entire market and your fund has declined as a result of negative **absolute return**.

NOMINAL vs. REAL RETURNS

GROWTH OF A HYPOTHETICAL \$100 IN THE S&P 500 INDEX, 1978-2008

■ Nominal Return ■ Real Return after Inflation, Taxes, and Fees



source: Thornburg Investment Management

Nominal and Real Return

Absolute return itself comes in a couple of forms that deserve mention.

Nominal return is the commonly stated, on-the-face-of-it return from an investment. The returns reported by mutual fund companies, the news media and others in the financial industry are usually **nominal returns**. “For the period 1926-2009 the S&P 500 Stock Index returned an annualized 9.8%” states the *nominal return*.

Real return reports return that has been adjusted to account for inflation—that is, for the effect of lost purchasing power—as well as for expenses and taxes, to be scrupulous. Because inflation makes up a large part of **nominal return**, **real return** is invariably much lower. **Real return** is also *more important*, since



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continued

inflation determines what your investment dollars will buy next year or when you retire. Again, consider the S&P 500 Index for the period 1979-2008. The annualized **real return** (net of inflation) for the period was 4.51%. Disappointing? Not when you consider that the **real return** from Treasury Bills (short-term government debt securities) for the same period was *minus* 1.24%.

Total Return

Absolute, nominal and **real** returns are usually reported in the form of **total return**, which includes both price appreciation (or depreciation) *and* any dividends or interest. Say the per-share price of your mutual fund appreciated 10% last year, rising from \$10 to \$11. If the fund also paid you a dividend of \$0.50 a share, your **total return** for the year was 15%, not 10%, and your mutual fund company rightly reports the higher percentage as the return. To assure apples-to-apples **relative-return** comparisons, returns for the S&P 500 Index and other financial-market indices are properly also reported as **total return** figures, including hypothetically re-invested dividends.

Knowing its different forms will help you examine any claims about return—with questions about the *real*, inflation-adjusted return, the return compared to a benchmark index or a Morningstar category average, and apples-to-apples comparisons of *total* returns.

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