Benchmarks, Returns & Fees Explained

Have you ever wondered how your investments are doing in comparison to their relative benchmarks (such as the TSX Composite Index or the MSCI Global Equity Index)? These indices act as benchmarks or “targets” and may be used to evaluate fund performance. Our intent is to select funds that out-perform their relative benchmark over a reasonable period. It is important however, not to rush to any conclusions based on a single year’s results.

How Are Investment Returns Calculated?

It is a regulatory requirement that the money-weighted method of calculating returns be used to determine your personal performance. The money-weighted return recognizes all external flows of money into and out of the portfolio and weighs periodic returns according to the assets under management during the period. In other words, a money-weighted return considers all factors relevant to the specific investor, including the timing of the investor’s decision to add or withdraw funds and the effect of those decisions on the portfolio.

Using Targeted Returns as a Benchmark

Our investment structures are comprised of GICs and investment funds with a variety of benchmarks. Your Fernhill Advisor will be able to tell you the benchmarks (targeted returns) that are specific to you.

For the purpose of evaluating one’s progress, it is important to remember that the decision to reposition one’s investments should not be determined based on a single year’s return since the targeted return constitutes a long-term benchmark over a period of many years. Furthermore, we must not forget that average returns include years in which the returns were negative and even good portfolio managers will underperform their benchmark from time to time.

The Treatment of Fees

The cost to manage an investment fund is referred to as the MER (Management Expense Ratio). The MER is a pre-determined percentage that is used to cover the expenses of operating the fund including taxes, the portfolio manager's fees and if applicable, the Advisor's commission. The MER is paid out of the portfolio's assets, regardless of whether the investment had a positive or negative return. When calculating an investment funds rate of return, the MER should not be included as this would be equivalent to counting it twice. However, if the investor pays any fees directly, such as by cheque, this should be included in the calculation for the rate of return. Fees paid directly by the investor or self-directed trustee fees paid within the plan should be treated as external cash flows and included in the calculation.

How to calculate Money-Weighted Returns

A money-weighted return is identical to the internal rate of return (IRR) associated with the portfolio's cash flows. The formula for this calculation appears to the right. You can also calculate the internal rate of return by using the XIRR function in Microsoft Excel.

$$IRR = r_a + \frac{NPV_a}{NPV_a - NPV_b}(r_b - r_a)$$

r_a = lower discount rate chosen
r_b = higher discount rate chosen
N_a = NPV at r_a
N_b = NPV at r_b

If you are curious about whether you're on target, speak with your Fernhill advisor about your rate of return and subsequent benchmark. Remember, it is important that a comparison not be determined solely on a single year's result. The longer the time frame used for comparison, the more accurate the comparison.