

>: How to grade your financial advisor...

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I literally speak with people on a daily basis that are virtually clueless about how to accurately rate the performance of their broker or investment newsletter. For example, I spoke with a person the other day who told me that he was unhappy with a service that he had owned for less than three weeks because the recommendations that he purchased were down.

I asked him if the person who ran the newsletter already e-mailed him to sell these recommendations, and of course he said "no?". I told him that stocks and the like will trade up, down, and sideways after you purchase them. What matters is where you eventually sell them. A loss on paper can easily turn back into a gain (especially with options) in no time. The reverse is true as well.

I just wanted to shed a little bit of light for those of you looking for better metrics on how truly grade the value of the advice that you are getting so that you can determine if the money that you are paying for the service is truly worth it.

MEASURING RETURNS FOR A SINGLE PERIOD:

Holding Period Return:

HPR= (Ending Price - Beginning Price + Cash dividend)/Beginning price

For example, let's say that today you purchased Citigroup (Symbol C on the NYSE) at \$27.5 and that you plan to hold it for a year. Also assume that by the end of the year the stock is trading at \$40 per share. Citigroup currently pays a dividend of \$.32 a quarter (\$1.28) per year. Which is a dividend yield of about 4.6 % (1.28/27.5). This will give you a holding period return of over 40%!

Many people forget to take into account the dividends that they receive. Dividends are VERY important to your overall return.

MEASURING RETURNS FOR MULTIPLE PERIODS:

Arithmetic Average:

Say that you are trying to assess how your broker did for you for the year 2007. In quarter one, the HPR(Holding Period Return) for your entire portfolio that he managed was 10%, quarter two it was 25%, quarter three it was minus 20% and in quarter four he was up 25% for you. Just take the number of HPR's and divide by the number of quarters. So for 2007, the arithmetic average of his performance would be 10 % { (10 25-20 25)/4 }.

This statistic is not the best one out there because it ignores compounding of returns. A better statistic is the geometric average.

Geometric Average (a.k.a. time - weighted return):

The textbook definition of this is the single per-period return that gives the same cumulative performance as the sequence of actual returns.

Savvy Wall Streeter's tend to measure returns using this statistic. Here's the way it would be done using the same numbers from above:

$$(1 + .10) \times (1 + .25) \times (1 - .20) \times (1 + .25) = (1 + r)^4$$

So that

$$r = 8.29\%$$

As you can see, the Geometric Average results in a lower return than the Arithmetic Average. This statistic is great to use when measuring the performance of how your portfolio is doing, as it presents an "apples-to-apples" comparison.

There are other statistics such as the Dollar-weighted return, etc, but the point of this article is to get you thinking the right way about how measure the returns that you are receiving. This article should just be a starting point.

In all fairness, you also need to measure the returns that you receive against the correct benchmark. For example, if you deal with an advisor or a newsletter that focuses on the tech sector then you want to use a tech sector benchmark to measure against his performance. You wouldn't want to measure his performance against consumer staples, for example.

The bottom line, folks, is measure your return using the right metric, and measure it against the right benchmark so that you don't think that you're

doing better than you really are.

Until the next time folks spend you're hard earned money wisely,

P.S. I would like to hear how you can tell if the advice that you receive is worth it.



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