A Holistic Approach to Discussing Investment Returns

When evaluating investment performance, the Compound Annual Growth Rate (CAGR) is frequently the main point of discussion. Although CAGR is a helpful indicator, it does not give a complete picture of investment performance. We must expand the conversation to cover the range of compound annual growth rates and the distribution of calendar year returns in order to protect investment advisors and set realistic expectations for retail investors. We can provide a more accurate assessment of investment performance and ensure that customers have reasonable expectations by getting beyond the linear thought process of returns.

CAGR is Better than Average Annual Returns – but has its Limitations:

When evaluating investment returns, Compound Annual Growth Rate (CAGR) proves to be a superior metric compared to Average Annual Return. Let's consider the following example: Imagine an investment with a year of remarkable performance, achieving a 50% return, followed by a year of significant loss, with a -50% return. If we start with an initial investment of $10,000, the first year's gain would increase it to $15,000, but the subsequent year's loss would reduce it to $7,500. While the average annual return appears to be 0%, the CAGR tells a different story. With a CAGR of -13%, it reflects the actual compounded growth rate over the two years, considering the volatility.

However, it is crucial to acknowledge that CAGR alone cannot provide a complete picture of performance, as it fails to capture the ups and downs that investors may experience along the way. This is where the range of compound annual growth rates and the distribution of calendar year returns come into play.

Understanding the Range of Compound Annual Growth Rates:

When evaluating investment performance, considering the range of Compound Annual Growth Rates (CAGR) over different rolling timeframes is crucial. It helps us move away from the linear approach many investors take, where they expect their portfolio to consistently match its historical CAGR. However, it is unrealistic to assume that a portfolio will always achieve its historical CAGR, especially during prolonged periods of stock market underperformance.

Suppose there is a period of market downturn where the portfolio experiences a few years of negative or low returns. In this scenario, the portfolio's CAGR for that specific rolling timeframe could be lower than its historical average. By acknowledging the range of CAGRs over different rolling timeframes, investors gain a more realistic perspective of how their portfolio can perform and are less likely to be disappointed when it doesn't precisely match the historical CAGR.

By understanding the importance of the range of CAGRs, investors can set more reasonable expectations for their investments. They recognize that market conditions can fluctuate, and their portfolio's performance may

deviate from the historical average. This awareness helps investors avoid unnecessary anxiety and allows for a more patient and long-term approach to investing.

Examining the Distribution of Calendar Year Returns:

The distribution of calendar year returns offers insights into the frequency and magnitude of gains and losses within a portfolio. It highlights the fact that returns are not linear, and different years can yield varying outcomes.

Let's take the example of the S&P 500, a widely followed stock market index, over the last twenty years. Its historical CAGR may be around 8% based on long-term data. However, if we analyze the annual returns for each individual year within that period, we discover that the actual returns have aligned with the historical CAGR less than 10% of the time.

Understanding that annual returns often deviate from the historical CAGR allows investors to have a more realistic perspective. It helps them appreciate that the market can fluctuate year by year and that temporary deviations from the long-term average are normal. By considering the distribution of calendar year returns, investors can better grasp the potential risks and rewards associated with their investments, making more informed decisions.

Conclusion:

Incorporating the range of compound annual growth rates (CAGR) and the distribution of calendar year returns into our discussions about investment performance is crucial for setting realistic expectations for retail investors. By doing so, we protect investors from having unrealistic return expectations and help them understand the inherent variability in investment returns.

When we only focus on the average CAGR, investors may develop the misconception that their portfolio will consistently achieve that exact return year after year. However, by considering the range of CAGRs, investors gain a better understanding of the potential ups and downs their portfolio may experience. They recognize that there will be years of higher returns, years of lower returns, and even negative returns. This knowledge allows them to have more reasonable expectations and reduces the likelihood of disappointment or panic during periods of market volatility.

Simultaneously, enhancing the discussion of investment performance also protects investment advisors. When advisors discuss the potential range of returns with their clients, they establish a more transparent and realistic dialogue. By helping clients understand that investment returns are not linear, advisors shield themselves from clients' potentially unwarranted blame or dissatisfaction during periods of underperformance. This approach helps strengthen the advisor-client relationship, as clients feel better informed and prepared for the fluctuations that can occur in the market.