Understanding rate of return

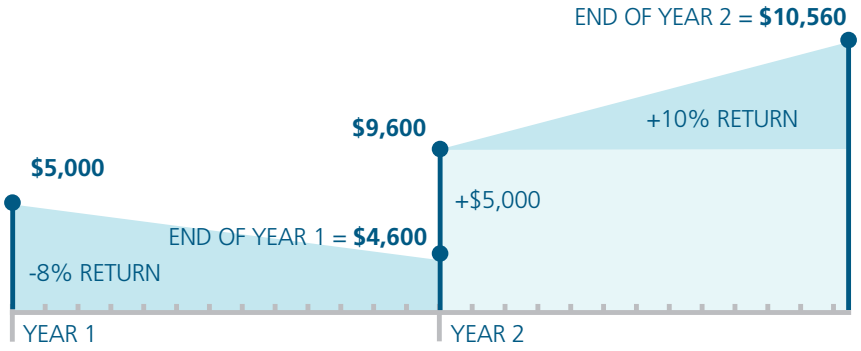
Credential

The Canadian investment industry uses several ways to calculate **rate of return.** Most investors are familiar with **time weighted rate of return** as these are the numbers published for mutual funds and other investments. Your own portfolio performance is calculated using **money weighted rate of return**. These returns can be very different, so let's understand the difference.

EXAMPLE

Let's say you invest $5,000 in a mutual fund and in the first year it loses 8%. In the second year you invest another $5,000 and the fund earns a 10% return. At the end of the second year, you would have $10,560.

Overall, you gained $560. The mutual fund had a return of 1.2% over the period, but your portfolio had a return of 7.51%. How can this be?



TIME WEIGHTED RATE OF RETURN

Think of time weighted rate of return as a measure of what happens in an account that buys a fund and then doesn't touch it — no additional contributions or withdrawals are made. It calculates performance that the fund manager generates by buying and selling investments within the fund. Each time period's return gets the same weight regardless of how much money was invested.

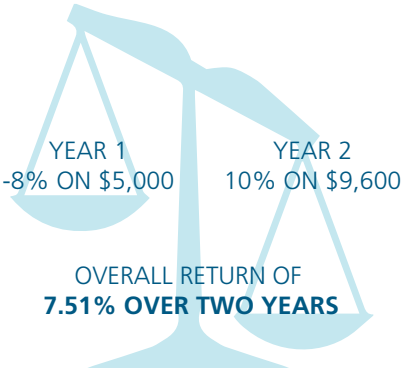
Useful for measuring how portfolio managers did

- Comparing performance of one portfolio manager to another, or to a benchmark
- Making forward looking assumptions in your financial plan

MONEY WEIGHTED RATE OF RETURN

Now think of your own account. Money weighted rate of return (MWRR) measures your own performance combined with the fund manager's performance. MWRR captures your cash flow across a time period and converts that into a personal rate of return. It's important to know that the size and timing of your deposits and withdrawals impacts your return.

In this example, the overall return is greater because the account had more money invested in the second year when the return was positive.



Useful for measuring how you did

- Capturing the individualized return of your own portfolio
- Seeing the overall growth of the portfolio
- Understanding different methodologies