Time-weighted vs. money-weighted returns

One of the most important conversations you will have with your advisor will be around how well your portfolio performed over time.

There are different ways of calculating the rate of return of an investment. However, **time-weighted** and **money-weighted** rate of returns are two of the most widely used methodologies.

Time-weighted method

The primary method used by the Canadian investment industry for years, it is widely used to calculate investor portfolio returns, as well as index and mutual fund returns. It only looks at the compounded rate of return of a portfolio over time and does not factor in the impact of your cash flows (contributions/withdrawals).

The time-weighted return is how the mutual fund performed, and can be used to compare returns to those of an index/ benchmark.

Money-weighted method

This method takes into account your decisions and trading activity in your portfolio – it factors in the impact of your cash flows. This means that your financial contributions/withdrawals to the portfolio can affect your personal rate of return.

The money-weighted return is how well your personal investment account performed.

Rate of return = gain/loss on an investment over a specified time period

Long-term performance factors:

Time-weighted: Measures impact of 1 & 2

Money-weighted: Measures impact of 1, 2 & 3

1. Market conditions

There is usually a positive correlation between how well the market is doing and portfolio performance. When the market does well, so do most portfolios. And conversely, when markets are down, the value of most portfolios follows suit.

2. Portfolio manager's skill

Portfolio managers add value by actively exploring the market to identify securities for investment opportunities. They can positively affect performance by selecting stocks that outperform the market. Conversely, they can also make decisions that will lead to picking stocks that underperform.

3. Your trading activity

Your own trading activity also influences portfolio performance. You either positively or negatively contribute to the overall performance based on the decision to add or withdraw money from the portfolio – the impact depends on timing and size of the transaction.

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Comparison

Type	Time-weighted rate of return (TWRR)	Money-weighted rate of return (MWRR)
Purpose	• Does not factor in the impact of your contributions/ withdrawals in and out of the portfolio • When changes to cash flow are made, it can impact portfolio performance, which is beyond the control of the portfolio manager • Method may be used to judge the portfolio manager's skills	• Factors in the impact of your contributions/withdrawals in and out of the portfolio • Represents a personal rate of return – every investor sees different returns depending on their unique trading decisions and behaviours • Method is influenced by the size and timing of your contributions/withdrawals
Answers the question	"How is the portfolio manager performing?"	"How is my portfolio performing relative to my investment objectives?"
Appropriate benchmark	Broad-based benchmarks that reflect the funds' investment mandates	Target return based on investor's financial plan
Advantages	• Better measure of portfolio manager's performance against a fund's benchmark • Can be used to compare similar funds' returns	• Better reflection of an investor's personal investment experience
Disadvantages	• Measure may not show the entire picture due to the impact that cash flows have on portfolio performance	• Cannot be used to evaluate portfolio manager's skills • Cannot be compared to other returns since the rate is unique to each individual

Same portfolio, different returns

Hypothetical example of how an investor's actions can affect a portfolio's return.

Vanessa, Tom and Jessica each invested $100,000 in identical investments on Dec. 31, 2014. Between their initial investment date and Sep. 5, 2015, the market declined 4% and then appreciated by 6% between Sep. 5 and Dec.31, 2015.

	Vanessa	Tom	Jessica
Investor's cash flow activity on Sep. 5, 2015	Contributed +$85,000 to her portfolio	Redeemed -$85,000 from his portfolio	No action taken
TWRR	**1.76%**	**1.76%**	**1.76%**
MWRR	**5.41%**	**-4.62%**	**1.76%**
Results	Vanessa's cash flow decisions led to a positive impact on the portfolio's performance. She made a large contribution right before a positive period.	Tom's cash flow decisions led to a negative impact on the portfolio's performance. He made a large redemption after a decline in the market and needed to sell investments at a lower price.	Jessica did not make any contributions or withdrawals so her decisions did not impact the portfolio's performance. As a result, both return figures are identical.

Contact your financial advisor today for more information on the performance of your portfolio.

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