An Investor Education Initiative

MIRAE ASSET Mutual Fund

by Mirae Asset Knowledge Academy

HOW DO YOU MEASURE INVESTMENT RETURNS?

Once you start investing, or for that matter even before you start, one question that may have struck you is "What returns will I make from this product?" While there is enough past information available on performance figures, whether short term or long term, it is necessary for you to also understand how exactly are those figures calculated and how do you read them?

To truly judge performance, you need to compute or understand returns earned from the product over different time periods.

Absolute returns

This is simply the gain or loss you make over a period expressed as a percentage of your investment cost. For example, if you had invested Rs.1 lakh six months ago and the current value of that investment is Rs.1.10 lakh, your absolute return is said to be 10%. This method of computing performance simply tells you in absolute terms how much your investment has risen or fallen over any given time period. Usually, this is considered as a relevant metric for time periods less than 1 year.

Annualized/CAGR returns

When the period of evaluation of returns is more than a year, you need to consider the compounding effect as well. This means that now you will have returns generated on both the initial amount of investment as well as on the gains you made on the initial investment, and this continues for as long as you remain invested. In this scenario, Compounded Annual Growth Rate (CAGR) provides an accurate picture of investment performance. Another way to put this is to figure out that if you have invested an amount over a period of 'n' years, then how much your investment has grown every year (year-on-year) over the 'n' years.

CAGR returns (represented by R) can be calculated using this formula: V = P(1+R/100)^n. Where P is the principal or the original investment amount, n is the number of years and R is the rate of return.

For example, if you had invested Rs. 1 lakh, three years ago and if this has grown to Rs. 1.50 lakh today, the CAGR on this investment is 14.47%. This means, your investment of Rs.1 lakh has grown at an average rate of 14.47% per annum for three years. It is important to note that this is an average and hence, the investment may or may not have grown at the same rate every year. It is quite possible that the return was negative in one or two of those years but at the end of the period, the net growth is 14.47% on average. CAGR hence presents an end-of-the-period picture while masking the interim movements in the investment value.

Note: Returns will include capital appreciation as well as income received (dividends, bonus).

Internal Rate of Return (IRR)

IRR helps you compare the profitability of different investment options. External factors such as inflation or existing interest rates are not considered while calculating this type of return and hence the return is based on only internal factors.

To understand IRR, you also need to understand the concept of NPV, or Net Present Value. All your investments will result in cash flows in the future in some manner- whether incoming or outgoing. But constantly rising prices (or inflation) mean that money in your hand today is theoretically more valuable than money you will get a few years in the future. So, anytime you can see money going away (cash outflows) or coming in (cash inflows) in the future, you should ask how much is all that money put together, actually worth today? Experts and smarter investors use this concept to understand how much you need to have today to achieve a financial goal with a certain future value. This is known as Net Present Value (NPV).

Now, the internal rate of return, or IRR, is that rate which results in zero NPV, after considering all cash inflows and outflows from a particular investment. It is also sometimes thought of as an investment 'break even rate', or the rate at which the present value of all future cash flows is equal to the initial investment you make. The higher the IRR, the faster will be the recovery of your initial investment and hence the more desirable the investment option. Naturally, you should consider investing in those options where IRR is greater than an established minimum return.

The assumption while calculating IRR is that future cash flows are at fixed intervals. When these cash flows are at irregular intervals, the discount rate is called XIRR. You may come across this term sometimes when you consider SIP returns in mutual funds. Since this is a technical measure, it can be difficult for the general retail investing public to implement.

Conclusion:

Evaluating investment performance is an important step of your investment activity. You need to judge if the returns generated by your investment are satisfactory. The returns should be compared with your own expectations, with similar and comparable investment products and also against the identified benchmark index. You also need to use the right measure of returns depending on the period being evaluated.

Key Takeaways