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Calculating Different Rates of Return

Across the investment industry, changes have been taking place that will help to provide investors with better information about their investment fees and portfolio performance. This is good news for the industry as it is expected to lead to better transparency for investors. As part of these changes, various performance reporting metrics will be standardized across the industry.

When it comes to reporting returns, there are different ways to calculate an investment's rate of return and each has different uses depending upon the situation. Generally, a time-weighted rate of return has been the more common method of calculation used within the industry. However, starting in 2017, new performance reports will be required to provide investors with a money-weighted rate of return.

Given these upcoming changes, we wanted to provide you with a general explanation of the difference between time-weighted and money-weighted rates of return:

Time-Weighted Rate of Return

For the period of return, time-weighted rates of return report the percentage return of an investment, regardless of the impact of any cash flows, such as contributions or withdrawals. This method is commonly used to calculate the performance of financial market indices and mutual funds, and is helpful when comparing the performance of an investment relative to a benchmark, as an example.

Money-Weighted Rate of Return

Money-weighted returns calculate the rate of return to include the impact of contributions to or withdrawals from an investment. For example, if an investor contributes a significant amount to an investment before it increases in value, the portfolio will benefit more in dollar terms from the positive investment performance. Conversely, if the investor withdraws a significant amount from the investment prior to it increasing in value, the portfolio will benefit less in dollar terms from the positive investment performance than had the withdrawal not been made. This method is helpful in communicating the client's personal performance relative to their financial plans or projections.

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Comparing the Two Rates of Return

The chart below shows the difference between a time-weighted and money-weighted rate of return. Using this hypothetical example, an investor contributes funds prior to the rise in the investment's value. As such, the portfolio benefits more in dollar terms from the timing of the contribution, and this is reflected in a higher money-weighted return.

Example: Difference between Time-Weighted and Money-Weighted Rates of Return

Date/Period	Investment Activity	Portfolio Value
Dec. 31, 2013	$10,000 initial investment	$10,000
Jan. 1, 2014 – Dec. 31, 2014	5% market loss (-5%)	$9,500
Dec. 31, 2014	$10,000 contribution	$19,500
Jan. 1, 2015 – Dec. 31, 2015	10% market gain (+10%)	$21,450
Time-Weighted (Annualized) Rate of Return		**2.2%[1]**
Money-Weighted (Annualized) Rate of Return		**4.8%[2]**

Note : Where R is the rate of return:

1. $(1+R) = (1+(-0.05)) \times (1+0.10) = 1.045$ *for 2 years, or 1.022 for annualized rate.* $R = 2.2\%$

2. $10{,}000 + 10{,}000 \div (1+R) = 21{,}450 \div (1+R)^2$. *As such,* $R = 4.8\%$