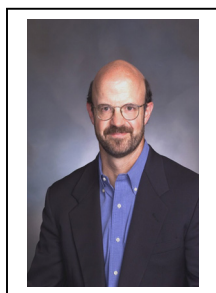


# Absolute vs. Relative Returns

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One hundred years ago, every investor believed in absolute return. The only number that mattered was the annual percentage earned on investments; the goal was to earn positive returns every year. To anyone who was concerned about building wealth, this was just common sense.

But the advent of Modern Portfolio Theory (MPT) and the rise of giant institutional investors brought a complete shift in investment thinking. Since the 1960s, mainstream money managers have measured success in terms of *relative performance* –, how their performance compares to an arbitrary benchmark such as the Standards & Poors 500 stock index.

It's all about beating the market – a philosophy that says, "What matters isn't whether you make or lose money this year, but how well your investments perform relative to your benchmark".

This "beat the market" mentality has undeniable appeal in a year when stocks are up 20%. But what happens when stocks are *down* 20%? That's when a manager can brag to a client, "Look what outstanding performance we've had! Your portfolio is only down 18%." Of course, that's not the end of the world if you're running a billion dollar pension fund. Even if the market plunges and you sustain big losses, you can afford to sit tight, stay calm and just ride it out. But what if you are a 55-year-old who has built up a stake of a million dollars and wants to live off the annual return? You can't pay the bills with relative performance.

For big institutional investors, the emphasis on relative performance does make sense. After all, you're investing **OPM** – "**Other People's Money**" – ostensibly with a long time horizon, defined by Modern Portfolio Theory as a *minimum* of 25 years. You know that markets continually fluctuate and that investment styles move in and out of favor. And you realize that in every year of this relative performance derby, there are bound to be winners and losers. *Everyone* can't beat the market because collectively, you and the other major institutions virtually *are* the market.

From this perspective, as long as you don't lag too far behind the market averages ("tracking errors" in institutional parlance); you will do fine over the long haul – that's relative performance in a nutshell.

The trouble is that the institutional mindset has permeated every facet of the investment world, trickling down to the retail side of the industry. Thus, the same techniques and strategies used to invest a

multibillion dollar pension fund are applied to a million dollar personal portfolio – yet the goals, the time horizon, and the sensitivity to losses are entirely different. In other words, what's good for General Motors may not be good for you.

For the affluent individuals, there *is* a better way: invest with absolute return objective – that is, with the goal of consistently achieving positive returns year in and year out. This single principle is what separates non-traditional managers from their traditional counterparts.

But while some non-traditional managers target annual returns of 30% or even higher, Jones-model managers and their clients shy away from the risk that accompany lofty return goals. Instead, they set an absolute rate of return target that's reasonable and attainable over any three-year period – say, 15% a year, net of all fees and transaction costs. Then they measure their success against some arbitrary industry benchmark.

For conservative investors, the key is to set a realistic absolute rate of return goal that you would be happy to achieve on an annual basis net of all fees. And then think of it in this way: If you can meet your personal investment goals, who cares how well the market or anybody else is doing?

**To learn more about absolute  
return investing, contact  
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Capital Investment Management (CIMCO) was founded by Christopher B. Pelley. The establishment of CIMCO was the result of his almost 30 years of experience working as an investment advisor in London, New York and Denver. CIMCO has developed an extremely talented team that serves hundreds of clients nationwide and throughout Europe.