Financially Speaking

Comparing Account Performance Isn't As Easy As It Seems

A couple of weeks ago I had a conversation with a new client that I have had with many clients in some form over the years. It went something like this:

"Should I be worried that the accounts you manage for me have declined in value at the start of the year?"

I responded with assurances that she should not, reminders that investment market volatility is normal and then put it in perspective by explaining that the 3.5% dip she had seen at that point was actually less than both the S&P 500 Index and the Barclays Aggregate Bond Index had pulled back for the year.

She was somewhat reassured, but one thing still didn't make sense to her, "I don't understand then why my 401k has made 3% so far this year?"

There it was – the most common misunderstanding of account performance that I come across, and I come across it often.

Fortunately, in her case I was able to fairly easily help to explain the issue. I had very recently looked at a statement for her 401k so knew it was all invested in one thing, and publicly available data showed it's year to date performance as negative 4.13% - meaning it had declined slightly more than her other accounts.

So why did she think that it had gained value when it had actually declined? She is a very smart lady who works with numbers every day. She certainly wasn't trying to be deceptive or give me a hard time, she legitimately was confused.

Contributions. The thing that she was failing to account for was the new money that had been added to her 401k during that time period. She was simply looking at the bottom line – the amount of money she had in her 401k on December 31st vs the amount of money that was in there on that day. Since the value was higher, she assumed it had made money in the form of investment increases.

In fact, when I talked her through it and got her to pull up the details of the account, she was able to see that the investment had declined during the period but there had also been several contributions deposited, including the employer's annual match, which made the account value still increase.

Over my quarter of a century of doing this I would say that it is almost more common than not that people overestimate the performance of their 401k or similar account that receives ongoing contributions. While that can have benefits as it helps to encourage people to continue contributing to them, it also has negatives as it can result in them unfairly viewing their other accounts as being somehow lacking or not as good.

Let's look at an example. Say you start the year with $1000 in your 401k and $1000 in your Roth IRA. During the year you add $10 a month to your 401k and your employer matches 50% of that, so adds another $5 a month.

At the end of the year your 401k is worth $1280 and our Roth IRA is worth $1100. How much did each one earn? They both earned $100.

The Roth IRA is simple to determine, you started at $1000, didn't add anything and ended at $1100 so the entire $100 increase is earnings. With the 401k the calculation is different. You started with $1000 but $15 per month was added to the account – multiple that times 12 months and it equals $180. To determine how much the 401k earned you can take the $1280 value, subtract the $180 of contributions and the $1000 starting value – you end up with $100, the same as the Roth IRA.

The same concept can work in reverse when you start taking money out of an account but that is conversation for another day, or perhaps another column.

As you look at your various accounts remember that to evaluate them fairly you have to factor in money that was added or withdrawn during the year. The bottom line matters but sometimes what goes into that bottom line matters too.

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Trisha Arndt, CFP@, is President of Wealth Strategies of Wisconsin Ltd, 951 Kimball Lane, Suite 110, Verona, WI 53593, 608-848-2400. Securities and Advisory Services offered through Commonwealth Financial Network, member FINRA/SIPC, a Registered Investment Advisor.