

# Digging deeper: Measuring performance

## 2. Relative return

### Relative return

The relative return (RR) of an asset measures how well an actively managed asset performed in relation to a benchmark. The results can be used to gauge if a fund manager has added more value for their clients.

This makes it an important method of measuring the performance of actively managed investments.

Unlike the holding period return (HPR), the RR is not expressed as a percentage but in percentage points or basis points (hundredths of a percentage point) – because it represents the difference between two percentages.

There are several ways of calculating an investment's RR. Two are:

- Arithmetic returns
- Geometric returns

#### Arithmetic returns

Formula for calculating the arithmetic relative return (RR) for a fund:

$$R = A - B$$

- > R = Relative Return (RR) on the investment
- > A = Asset's return (Holding Period Return (HPR))
- > B = Benchmark return

#### Example

A = Fund returned 16% over the holding period

B = The large-cap benchmark returned 14.5%

**Relative return = 16% – 14.5% = 1.5 percentage points (or 150 basis points)**

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## Geometric returns

Sometimes geometric calculations are used to show the RR. This is because the geometric return reflects the compounding process involved in returns.

Geometric returns are seen as a more accurate representation of investment performance.

Notably, geometric returns tend to be lower than arithmetic returns.

**Formula for calculating the geometric relative return (RR) for a fund:**

$$R = \frac{(1 + A)}{(1 + B)}$$

- > R = Relative return (RR) on the investment
- > A = Asset's return (Holding Period Return (HPR))
- > B = Benchmark return

### Example

A = Fund returned 16% over the holding period

B = The large-cap benchmark returned 14.5%

$$\text{Geometric relative return} = \frac{(1 + 0.16)}{(1 + 0.145)} = 1.01$$

**Geometric return of 1.01 percentage points (or 101 basis points).**

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