

## ***Some Thoughts on Portfolio Turnover***

***The Loom and Gloom of Taxes.*** A few weeks ago, as remuneration for her chores, Will took his daughter Annie to buy \$10 worth of rubber bands for the Rainbow Loom she uses to weave colorful rubber band bracelets. She was delighted to discover they were on sale—4 packages for \$10. (Yes, it is quite a business, but Will checked and it's not a public company.) When the cashier rang up the total, Will (the Heartless) informed Annie she had exceeded her wages by 86 cents because of the taxes and that she would have to make up this amount. Annie objected: "But Dada, tax doesn't exist in my world."

Unfortunately for the rest of us, taxes do exist in our world and affect us even in ways we may not be aware of. Capital gains taxes, for example, are one of the many factors that influence money managers' decisions to buy and sell stocks for their portfolios. The more frequently profits are taken, the greater the tax impact on performance. One statistic investors can use to measure this trade frequency is portfolio turnover.

***A Brief Explanation of Portfolio Turnover.*** Portfolio turnover is calculated by dividing the value of securities bought or sold in a 12-month period (*whichever is less*) by the value of the assets in the portfolio. (Cash equivalents and most options are excluded from the calculation.) A portfolio turnover of 100%, for example, means that the entire value of the portfolio was bought and sold ("turned over") during the year. A portfolio turnover of 200% means that twice the value of the portfolio was bought and sold during the year. A portfolio turnover of 50% means that half of the portfolio's value was turned over during the 12-month period. But remember the whichever-is-less rule noted above. If an investor adds several positions to a portfolio during a 12-month period without selling any, the portfolio turnover is zero.

We can calculate the average holding period of each security by dividing the 12-month period by the portfolio turnover. For example, the portfolio above with the 50% turnover has an average holding period of two years ( $12 \text{ months} / .50 = 24 \text{ months}$ ), which means that each stock in the portfolio was held for an *average* of two years. A portfolio with a 200% turnover has an average holding period of 6 months ( $12 \text{ months} / 2.0 = 6 \text{ months}$ ).

***The Impact of Capital Gains Taxes.*** Everything else being equal, a taxable portfolio that harvests its winners more frequently will generate a smaller after-tax gain than one that holds its winners longer since each tax bite reduces the investable proceeds. A simple example

illustrates the principle. Assume an initial purchase of 1000 shares at \$10 per share, a capital gains rate of 20%, and yearly gains of 100%. (Perhaps we have convinced the Rainbow Loom company to go public.) Investor A sells all of his stock a few days after the end of Year 1 for \$20 per share. A couple of months later, he is afforded the opportunity to re-establish his position at the same \$20 stock price he sold it for and purchases 900 shares with his after-tax proceeds of \$18,000. (Remember he has to pay a 20% tax on the \$10,000 capital gain.) When the 900 shares he re-purchases double to \$40 per share by the end of Year 3, he sells his \$36,000 position, pays taxes of \$3600 on the \$18,000 gain, and nets **\$32,400**. Investor B, on the other hand, does not sell at the end of Year 1 and re-enter at the same price. She holds until the end of Year 3 and sells at \$40 per share. Her proceeds equal \$40,000, and her pre-tax gain is \$30,000. After the 20% tax hit, she still has **\$34,000**, \$1600 more than Investor A, even though the net price appreciation both investors enjoyed in the stock (30 points) was exactly the same.

***The Impact of Transaction Costs.*** Not all of the costs of trading, of course, are paid to the IRS. Every trade in a portfolio will incur transaction costs, whether it is a broker commission, mark-up/mark-down, or some other fee (or a combination of these costs). Even if per trade transaction costs are low, a high portfolio turnover will eat into total returns over time. A portfolio with a turnover of 25%, of course, may be expected to generate just one-fourth of the transaction expenses of a portfolio with a turnover of 100%. If these portfolios have 20 positions and the average trade commission is \$30, the portfolio with the higher turnover will pay \$900 more per year in commissions than the portfolio with the lower turnover. Over time, these additional expenses will substantially erode returns.

***Effect on Performance.*** So from a cost standpoint, a portfolio with a lower turnover will always beat one with a higher turnover, even before taxes. It is therefore not surprising to learn that mutual funds with a lower portfolio turnover tend to outperform those that buy and sell holdings more frequently. According to a study using data from Morningstar, the top-rated fund in each of its 9 domestic fund categories—from Small-Cap Value to Large-Cap Growth and everything in between—had portfolio turnover rates **lower** than the category average turnover rate. *The category average turnover equaled 91%, but the average turnover of the **top-rated** funds in each category was a far lower 27%.*

***Sterling Capital Management's Portfolio Turnover.*** Because the undervalued companies in which Sterling Capital invests generally do not become fully valued by the market overnight, we do not move in and out of our positions quickly. As a result of these typically long holding periods, our portfolio turnover is usually very low. For example, in 2013, the portfolio turnover on the assets under our management (on a combined basis) was less than 15%. Such a low portfolio turnover will not of itself produce superior returns, but it is a long step in the right direction.

Thanks for reading.

**(Next Time: Are there benefits to a low portfolio turnover beyond reducing portfolio management costs? Can portfolio turnover be too low? And is there such a thing as an optimum portfolio turnover?)**

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