STERLING CAPITAL
MANAGEMENT, INC.
Registered Investment Advisor

A Little More on Portfolio Turnover

Non-cost Considerations. As you may remember, our last note brought the unpleasant news of how taxes had become part of Annie's world and then examined how a low portfolio turnover could reduce the impact of capital gains taxes and other costs on performance. If our analysis had stopped there, we would have concluded that never selling a portfolio's positions would generate the highest returns possible. Since money managers don't do this, we can safely infer that there must be some benefit to selling stocks in a portfolio. But how often should a money manager initiate and close positions? Is there a portfolio turnover range that leads to optimum results?

Chaos Theory. Addressing this issue, Clifford Dow, the Chief Investment Officer of the Dow Publishing Company, recently asserted that holding positions for exceptionally long periods will generally not produce superior returns since predictions about earnings far into the future are considerably less accurate than predictions of not-so-distant earnings. This intuitive declaration finds support in chaos theory, which states that the effects of unforeseen events have non-linear impacts that can make a shambles of otherwise accurate predictions. In other words, an analyst might correctly forecast 99% of the determinants of a stock's future price, but the 1% that he misses may have an impact on his prediction of far greater than 1%. If the analyst has initiated a position in the stock based on this prediction, the return on the investment could fall far short of what was expected despite his near-perfect evaluation of the variables affecting the long-term price movement of the stock. The longer the time period, the more likely these non-linear, unanticipated events are to occur. A good example of such a chaotic event is fracking, a technique that uses pressurized liquids to extract previously unavailable oil and gas from shale formations. An analyst who years ago correctly forecast every other variable affecting a gas exploration company's fortunes but did not foresee the advancements in fracking technology would have badly missed on his prediction of the stock's future price.

On the other hand, Dow writes, holding stocks for very short periods of time will also not likely produce strong rates of return. Events occurring in the near term are by nature easier to predict than events in the future, and there will consequently be widespread agreement among analysts about the movement of a stock's price in the short run. Stated differently, because the near-term predicted events are already discounted in the price of the stock, above-average gains are not likely to be realized.

Attempting to quantify these principles of chaos theory as they apply to stock prices, Edgar Peters examined the behavior of hundreds of stocks going back to 1888 and concluded that the average cycle or "memory" of a stock is around 48 months. In other words, the current conditions that influence a company's performance and therefore its stock price will persist, on average, for 48 months. The optimum holding period for a typical stock, therefore, is the same 48 months since its price movement beyond that time frame is not predictable. The 48-month holding period corresponds to a portfolio turnover of 25%. *This 25% optimum portfolio turnover for all stocks is strikingly consistent with the conclusions based on the Morningstar mutual fund data discussed in our earlier mailing. This data revealed that the average turnover of the top-rated funds in the nine Morningstar fund categories was 27%.*

Peters also found that although 48 months was the average memory for all the stocks he studied, certain sectors had different cycles. Tech stocks, for example, have shorter cycles of around 18 months (implying a portfolio turnover of 67%) because of higher rates of innovation, which truncate the duration of current technology's influence on a stock's fortunes.

Other Managers on Low Portfolio Turnover. Despite the presence of evidence suggesting that the optimum turnover is 25%, very few money managers expressly incorporate the 25% target into their investment strategy. Many, however, attain turnover rates close to that figure or lower because of their patient, value-oriented approaches. As Eric Ende of First Pacific Advisors noted, even those companies that generate high returns and re-invest their cash flows profitably must be given a reasonable opportunity to execute their plan. For "this virtuous process to bear fruit," states Ende, a long-term holding period is required.

First Eagle Funds' Matthew McLennan attributes their portfolio's 5-year average holding period in part to the tremendous difficulty of accurately predicting short-term moves and the desire to take emotion out of the process: "[P]eople are trying to zig and zag ahead of every market turn that they're hoping they can forecast with scientific precision. We like to plant seeds and then watch the trees grow."

Preston Athey, who manages a small-cap value fund for T. Rowe Price that recently had a portfolio turnover of 8%, agrees. This low turnover "is driven by the belief that if you've truly done your upfront research well, you should have the patience and courage to let ideas work."

Legg Mason's Bill Miller has written that the Taoist philosophy of *wei wu wei*, loosely translated as the action of non-action, underlies his investment philosophy. He adds: "We are mostly inert when it comes to shuffling the portfolio around, with turnover that has averaged in the 15 to 20 percent range. Many funds . . . constantly react to events or try to take advantage of short-term price moves. We usually do neither. We believe successful investing involves anticipating change, not reacting to it."

Steve Romick has offered a practical reason for First Pacific's 5-year holding periods: "The reality is that we can't do the level of due diligence we want on each idea and also turn the portfolio over quickly by constantly trading our good ideas for better ones."

Sterling Capital's View. Like most other investment advisers, Sterling Capital Management does not set a portfolio turnover target, but we are certainly aware that our 15% portfolio turnover is much lower than the mean for managed portfolios. We are confident that this low turnover will continue to benefit our clients.

We are also aware that our turnover runs slightly under the theoretical optimum of 25%. This may suggest that we are at times too patient with a few of our ideas. But it may simply reflect that our portfolios have less-than-average exposure to high-risk, cutting edge technology companies that, as earlier noted, tend to have shorter investment cycles because of innovation-triggered disruptions. We are constantly reviewing how we execute our philosophy, and we will continue to give this question serious thought.

But even if we slightly reduce the holding periods of a few of our stocks, our approach ensures that our portfolio turnover will remain low, giving the market sufficient time to re-price under-valued securities and making capital gains taxes and other costs a little less part of our world.

We think Annie would approve.

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