MYTH: EXCESSIVE TRADING LEADS TO SUB-PAR PERFORMANCE

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The subject of portfolio turnover is often treated quite simplistically. Frequently, investors looking at a fund that is accompanied by a high turnover rate conclude that if that fund had zero turnover, its assets would have been higher by the sum of all trading costs.

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Knowledge of the turn-over rate for any fund is about as helpful as knowing the height and weight of its portfolio manager. By itself, it is an entirely useless statistic. It provides only a partial answer in determining whether or not turnover is beneficial or harmful to returns. What is more pertinent in dealing with this question is looking at the difference in return generated between stocks that are bought and stocks that are sold while taking trading costs into account.

Consider a fund that makes a switch out of stock A into new stock B. If new stock B outperforms old stock A by a mere 1%, that trade more than covers the trading costs which have been compressed to a fraction of a penny today.

Rarely is this question asked and even more rarely is this question answered. Instead, investors simplistically conclude that if a fund returned 30% in one year and total trading costs amounted to 2%, the fund would have earned 32% if the portfolio remained static. This view fails to consider the performance differential between the stocks that are bought and sold.

In the 1970s, AG Becker, the first pension fund consultant in the business, addressed the subject of turnover and found that the five portfolios in their database with the highest turnover rates generated much better returns than the five portfolios with the lowest turnover rates.

In another study, Investor's Business Daily reported for periods ending in 1999 over one-three-five-year time frames that domestic equity funds with the highest turnover rates turned in the highest returns. In 1999, funds with turnover rates below 50% provided an average return of 15.6%. By comparison, funds with very high turnover, above 500% provided an average return of 106%. This was a most unusual year as 177 funds achieved triple digit returns.

Russ Werner conducted a study on a group of equity funds for the years 1974 - 1995 at the University of Maryland. He compared the top performing 20% in the group to the bottom 20% in each year and found good performance frequently occurred in the funds with the highest turnover.

Business conditions can change very fast. Funds that are quick to make changes to these conditions are frequently found among the best performers. History shows that high turnover funds are capable of producing superior returns contrary to simplistic assumptions that run counter to the evidence.

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