LET'S TALK ABOUT TURNOVER: THE HOT, THE COLD, AND THE JUST RIGHT

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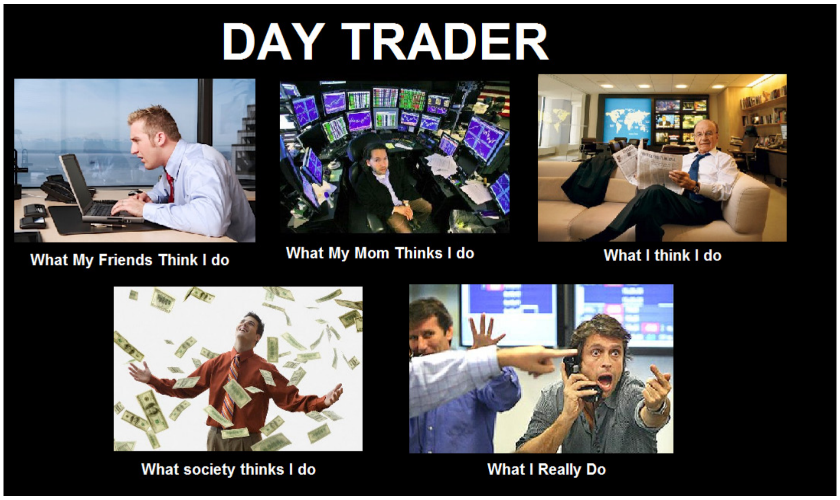
One of many misunderstood or ignored terms in asset management is turnover. A portfolio's turnover is basically the percentage of the portfolio that changes during the course of a year. The inverse of portfolio turnover is the average number of years a security is held.

For example, if you own 100 stocks in equal dollar value, and you sell 10 of them during the year and buy 10 new ones, your turnover is 10%, and your average hold period is 10 years.

In terms of turnover, we can compare investment styles to the Goldilocks tale. Either the investor follows the Warren Buffet strategy (buys companies, basically holds them forever) or takes it to the opposite extreme by day trading (flipping stocks many times during the same day). We have met successful investors at both extremes, but regular readers of this blog can probably guess which bowl of porridge we would choose. We believe it's important to do heavy vetting up front when picking companies. By understanding how a company operates and what's on the horizon for its management and product development, it's likely you can better justify holding onto it despite short term market events that impact its share price temporarily. While nobody has a crystal ball, we believe doing your homework can vastly increase your chances of predicting a company's long term success.

But regardless of where a fund's strategy falls on the turnover spectrum, investors should be aware of how turnover may affect their returns. Many investors don't realize that transaction fees aren't included in the expense ratio they already pay—the expense ratio typically only includes marketing and administrative fees. As such, if a fund has a high turnover rate, investors could be forking over quite a bit in transaction fees unknowingly, which could in turn eat into their returns. Talk about your cold porridge.



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On one far end of the spectrum, day traders tend to focus on stocks (stock movement trends, complex charting, etc.), and ignore information about companies (competitive situation, valuation, industry outlook, management team, etc.). This strategy works for some, but doesn't typically include the thorough research we'd endorse. Additionally, there are transaction fees on purchases and sales- typically those come right out of investors' pockets. Throw in the taxes, and you can sometimes slash your profit from a trade in half. So, if you are considering this strategy, I implore you to ask yourself if these rapid-fire trades are worth it.

(For an insider perspective on day trading, take a look at day trading website www.investoo.com)

Some investors concoct a peculiar fourth bowl of porridge, one with some rather puzzling ingredients. These firms do fundamental research on companies, yet still have lofty turnover levels (100% or higher, implying that stocks are held just one year or less on average). Frankly, we find this confusing. Furthermore, we see a few problems with this and would like to pose these questions:

1. Did these investors really do their homework prior to buying?

2. Did they plan to hold these stocks for this short of a period?

3. Are they negatively impacted by trading costs?

4. Do they find taxes on short term gains burdensome?

We tend to doubt any of these are the case. While we don't ascribe to all of his views, we agree with Vanguard founder John Bogle when he suggests that investors "Buy right and hold tight." Turnover is expensive, and high turnover generally results in mediocre performance. For us, carefully researching companies and holding them for the long haul results in a delicious bowl of porridge.

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