



Stirring the Pot

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Have you ever considered that investing in stocks is a lot like cooking in a crock pot? They both need minimal intervention and stirring once the right ingredients have been measured and assembled. Unfortunately, this analogy is lost on most investors who tend to stir their pots too often - and often to their own detriment.

Various studies have quantified the cost to investors of "stirring the pot" too often including one by Kenneth French from Dartmouth College who estimated investors collectively spend about \$100 billion per year trying to outperform the stock market by paying others to stir their investment pots. Unfortunately, most of those people are left with little flavor on their palate and less money in their investment portfolio.

One specific expense of such stirring often overlooked by investors is the cost of turnover in their portfolios. Turnover refers to how frequently holdings within a portfolio are replaced as a result of buying or selling stocks. Turnover is measured in percentages, so a turnover rate of 100 percent means on average all the stocks within a given portfolio are replaced within one year.

The average mutual fund has a turnover rate of about 100 percent, and there are funds with turnover rates exceeding 500 percent (which means they held their stocks for less than three months before selling) and some with less than 10 percent turnover (for a holding period of more than 10 years).

Here's how this type of stirring can deplete the flavor in your investment crock pot. The estimated cost of buying or selling stocks within professionally managed mutual funds is about 0.5 percent for every 100 percent of turnover. Imagine investing \$100,000 in a fund with 10 percent turnover which would incur transaction costs of 0.05 percent per year compared with the portfolio with 500 percent turnover and corresponding costs of 2.5 percent per year. This almost 2.5 percent difference over 20 years (assuming a gross return of 8 percent) would result in \$462,000 for the 10 percent portfolio versus \$321,000 for the 500 percent portfolio. The difference in outcomes exceeds the original amount invested!

Understanding turnover is important because it is one of the things you can control as an investor. You can identify the turnover rate of mutual funds you own by looking at websites such as www.morningstar.com or, if you have a portfolio of individual stocks in a nonretirement account, look at your Schedule D on your tax return to see how often trades are being made in your portfolio. If you have multiple pages of trades listed, chances are the turnover rate is fairly high.



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Stirring your crock pot less and rotating the stocks in your portfolio less will lead to a more delicious meal and a better rate of return on your investments.

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