Complimentary Chapter

from

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Fees, Turnover and Accountability

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"Sunshine all the time makes a desert."

~ Arab proverb

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Objective:

Maintaining the DIY low-cost advantage.

Undoubtedly, one of the most appealing aspects of retail investing is stemming the outflow of fees paid for professional services. According to the Morningstar Global Fund Study of 2019,[1] the median management expense ratio (MER)[2] for actively managed US Equity Funds was 0.67%. For a $200,000 portfolio, that translates annually into $1,340 of costs. At $10/trade, this would represent about 134 trades annually to a retail investor (11 trades/month).

According to the same study, Canadians pay the third highest management fees among developed countries. In 2018, the median MER for a Canadian Equity Fund was 2.28%. For a $200,000 portfolio, this translates into $4,560 annually or 456 trades annually at $10/trade.[3]

Since trading commissions are a retail investors primary cost, DIY investors are in a unique position to control their total investment management costs. And with more trading platforms now offering zero commissions, it makes the DIY choice even more compelling. However, a 2000 study titled "Trading is Hazardous to your Wealth" published by Brad B. Barber and Terrance Odean in *The Journal of Finance* openly questions the merit of commission-free trading.[4]

Turnover Ratio

In this study, they reviewed the stock trading practices of 66,645 households over six years (1991–1996). They sorted the data into five equal groups according to the number of transactions performed (low to high). Figure 17.1 shows the Gross and Net performance results and the portfolio turnover[5] for each group compared to the S&P 500. Here were their findings:

- The lowest trading group (9 stock trades in six years) had the highest net average annual performance and outperformed the S&P 500 (18.5% vs. 17.9%) (dotted line).
- The highest trading group (Turnover Ratio = 283%) had the lowest net average annual performance and underperformed the S&P 500 by 6.5% (11.4% vs. 17.9%) (dashed line).
- Surprisingly, the gross annual performance for all groups (before deducting trading commissions) was nearly identical (white bars) (average = 18.5%).
- The average annual household Turnover Ratio was 75%.

[1] https://www.morningstar.com/content/dam/marketing/shared/pdfs/Research/GIE_2019_v4.5.pdf?utm_source=eloqua&utm_medium=email&utm_campaign=&utm_content=18780 (US = P. 53, Canada = P. 23) (Accessed 26 September 2021).

[2] MER includes management fees and fund operating expenses.

[3] According to the 2019 Globe & Mail annual review of discount brokerage platforms, the average commission charged per trade in Canada was between $6.95 and $10. (Accessed 26 September 2021).

[4] Barber, B.M. & Odean, T. (April 2000) Trading is Hazardous to Your Wealth. *The Journal of Finance.* 55, 773–806. http://faculty.haas.berkeley.edu/odean/Papers_current_versions/Individual_Investor_Performance_Final.pdf (Accessed 26 September 2021).

[5] A turnover ratio reflects how actively a portfolio is managed in a year. A ratio of 283% means that the value of the entire portfolio was traded nearly three full times during the year.

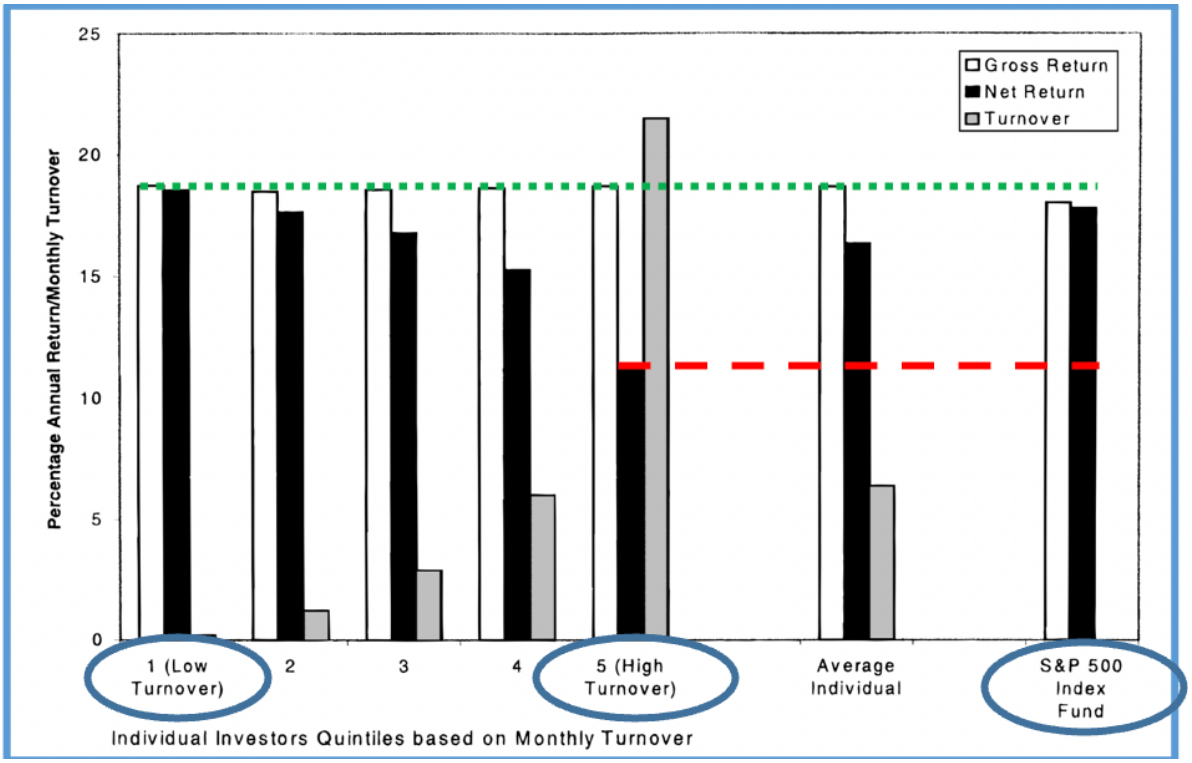

Figure 17.1 Individual investors quintiles based on monthly turnover.

Source: Adapted from "Trading Is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors" by Brad M. Barber and Terrance Odean published in the Journal of Finance Vol. LV, No.2, April 2000.

Trading is like "Commuting"

Frequent trading could be analogous to a morning commute to work. With each lane change, aggressive drivers cause greater wear and tear on the vehicle, increase CO^2 emissions, and introduce undue uncertainty for other drivers. Data from the Centre for Accident Research & Road Safety out of Australia shows that for distances of 10k or less, the commute times are almost identical for all drivers, yet the accident rate for more aggressive drivers was double for driving just 5k/hour over the speed limit.[6] Trying to shave a few minutes off the morning commute is more telling about the person than the purpose.

As it turns out, the behavior is repeated frequently by the same drivers because some are just hardwired to be more aggressive despite the additional costs, risks and low probability of actually achieving a better outcome.

According to the Barber and Odean study, frequent trading clearly does not improve results, yet does incur more costs, which undermine any additional gains generated from the few winning trades. Frequent trading appeals to certain investors because they believe they can better control their financial destiny with more activity. Unfortunately, it also introduces undue mistakes, increased costs and, like gambling in Vegas, the house always wins. Trading commissions paid to the discount trading platforms eventually erode the excess returns.

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[6] https://blog.fleetcomplete.com/feel-the-need-for-speed-think-again.

Moral of the story: Investing in quality assets and reduced trading can be beneficial to your wealth and your health. Make a habit of setting proactive trades, then enjoy the commute.

What about the Sell?

Frequent trading is the most common retail investing strategy. If the wins outpace the losses, then carry on. But the behavior gap is undeniable proof that something is amiss for the masses.

Barber and Odean's study noted that the average annual household Turnover Ratio was 75%. This means that each stock is held, on average, for just over one year. Such high turnover reflects little trust in the underlying corporate management teams to create long-term value. Instead, investors are relying almost exclusively on personal trading skills to beat the market.

Why a stock is bought and why it is sold are usually quite different reasons. Investors only buy to make money. Why they sell and when they sell requires an entire thesis to understand but is highly aligned with our emotions.

Note: The average Turnover Ratio (TR) for a US Equity Fund in 2019 was 63%.[7]

Whether retail or institutional, the goal should be to reduce a portfolio's TR to 30% or less. Which would mean holding your stock positions for at least three years. This likely requires a paradigm shift.

Calculating a Personal Turnover Ratio (TR)

Knowing our portfolio Turnover Ratio could be valuable data. If your trading platform does not automatically provide a personal TR, here's a simplified formula:

1. Identify the Total Proceeds realized from the sale of all assets during a calendar year. This figure is usually readily available from a trading platform. It is also required for annually calculating capital gains/losses for income taxes purposes. When you do your taxes, consider also checking your TR.
2. Divide "A" by the average portfolio value (= Beginning of Year Portfolio Value + Year-end Portfolio Value) / 2).
3. Multiply B x 100 = TR.

[7] https://www.investopedia.com/articles/mutualfund/09/mutual-fund-turnover-rate.asp (Accessed 26 September 2021).

Results

The annual target TR should be around 30%. Yet, if it is more than 50%, an investor might benefit from reviewing their recent trading history. Download your Trading Report for a select period (i.e. month/quarter) and review the report according to these 6 parameters:

1. Count the total # of Profitable Trades.
2. Count the total # of Losing Trades.
3. Calculate the total gains.
4. Calculate the total losses.
5. Sum-up the total commissions paid.
6. Highlight the Sell Trades for individual reviews (ignore Buys and Options transactions).

Quick Assessment

- **The number of winning trades should exceed the losing trades** (= a–b).
- **The gains generated should exceed the losses** (= c–d).
- **Analyze individual "Sell" trades.** Identify which ones were justified (e.g. needing cash, defensive Stop Loss trade, rebalancing trims, replacing one stock with a better profile) and which ones were spontaneous due to changes in a stock's share price (e.g. reactionary or capitulation trades). Analyzing and learning to avoid these latter trades could offer significant improvement in performance.

Comments

To be fair, analyzing just one period will not likely identify any key trends. Do this review periodically (at least once a year for a select month/quarter), then compare between the periods. This will help to determine whether an investor is winning by skill or by chance.

If the TR is high, this could suggest "sport-trading" where trades are deployed similar to placing bets at a casino. The biggest challenge though, is when an investor generates profits with a few big trades while incurring many losing trades. This likely indicates a low risk tolerance and a lack of trust in the chosen stocks.

To invest in growth stocks, an investor needs to have the stomach to absorb periodic declines up to 25%-30%. This is the nature of the beast. If volatility is so deeply troubling, to the point of sleep loss, then the investor could re-evaluate their asset mix (see Chapter 4: Setting the Asset Mix) or could purposefully choose growth stocks with less variance (see Chapter 9: The Brains and the Brawn).

At year end, if an investor is underperforming the S&P 500 Index and is incurring high volatility and trading costs exceeding $150/month ($1,800/year), investing in a low-cost, broad-market ETF Fund might bring less frustration and better results.

“Zen” Trading

By putting trades through a decision-making checklist (see Chapter 14: The Buy-in, or Chapter 20: The Sell), the trading frequency should naturally slow down. Think back to Chapter 2. Neutralizing our energy frequency (200–400 MHz) can be achieved by taking a break, controlled breathing, or any way to steer our thoughts away from the trading screen. Good trades are based on clear purpose, such as:

- Selling stocks to raise capital for life’s other obligations.
- Rebalancing the portfolio at thresholds targets.
- Selling a stock due to a specific material concern.
- Buying a new stock to improve performance or better diversify the portfolio.

Better Trading Habits

Six habits that can lead to improved trading decisions:

1. **Every trade should align with your long-term objectives.** Each decision should either enhance a portfolio’s performance, reduce volatility, or eliminate a specific risk. Before buying that next stock, confirm its correlation coefficient (see Chapter 11: 3+ Degrees of Diversification).
2. **Triangulate your research** to reinforce convictions and reduce capitulations.
3. **Reduce trading temptations** by spending less time at the trading screen.
4. **Non-material reasons should not be a deal-breaker.** Let the news settle. Consider buying more shares.
5. **Material events are a good reason to sell.** Digest the news. Lack of a corporate action plan or denials are good reasons to sell. Trust is everything. Liquidate over several sessions. With quality stocks, this should be relatively infrequent.
6. **Be prepared to defend your trading decisions.** Having to discuss or explain your decisions to an outsider (partner/friend/mentor?) can improve the investing process. Pros are obligated to do this. Feedback is a necessary evil on the path towards enlightenment.

Behavior Buffers

Since behavior is difficult to change, consider buffering yourself from having to make front-line decisions.

1. **Pre-plan rebalancing**. Either set up a Limit Sell order above the advancing price to be triggered upon reaching a predetermined threshold gain, or once the shares arrive at the threshold, set a Trailing Stop-Loss (TSL) Limit order to follow along behind a rising stock until the position eventually pulls back and triggers a sale.
2. **Protect the original capital invested.** Set up standing Stop-Loss Limit orders about 10–15% below a stock’s Adjusted Cost Base (ACB). Once the stock price rises above their ACB, raise the Stop-Loss (SL) Limit order above the ACB. This will protect a portion (25–50%?) of your original capital from an outright collapse, depending upon

how much of your capital you wish to protect. This could remain in place indefinitely until triggered, if ever, and should be gradually advanced to protect even more gains.

3. **Protect some of the accrued gains.** Set up a standing TSL Limit order about 10–15% behind a current stock's price to protect some of the accrued gains (25%?). Once triggered, don't question the market. Preserve the cash raised for a more compelling buying opportunity.
4. **Protect more of the accrued gains.** Once substantial gains have been accrued, consider setting a ladder of standing TSL Limit orders, each about 5–10% behind one another. These are useful to lock in incremental gains when a share price collapses. If it never does, the TSL Limit orders will continue to rise along with the advancing share price.
5. **Low-maintenance, low-cost investing.** Consider investing a portion of the core portfolio in low-cost, low-maintenance broad-market ETFs: SPY (S&P 500), QQQ (NASDAQ) and XIU (TSE) and complement them with select individual stocks. This aligns your portfolio even closer to the market.

Measuring Your Value Proposition

Each year-end, an investor could assess their value proposition (VP) across three metrics:

1. Performance Profile
2. Costs
3. Time & Effort

1. **Performance Profile** (results vs volatility) – Your trading platform or year-end account statements should provide performance data. Compare the year's absolute performance against the three categories below. Also compare your performance relative to the degree of volatility incurred ("Sharpe Ratio" see Chapter 9: Brains and the Brawn) and relative to the absolute volatility incurred to:
   - **The Market** – the S&P 500 Index.
   - **The Pros -** check Morningstar Inc. for the average performance of North American Equity Mutual Funds.
   - **Your Required Rate of Return** – check your Investment Policy Statement.[8] Are you on track?

Note: Cash should be included in performance calculations since it is meant for tactical purposes.

[8] See Chapter 8 for an IPS template. Chapter 4 shares how to calculate a personal required rate of return.

2. **Costs** – Download the total trading commission details from your trading platform. To calculate your personal MER, divide this figure by the average value of your total portfolio (= portfolio value at the beginning of the year + the portfolio value at the end of the year / 2 X 100). Compare this percentage figure in two ways:
    - Relative to the costs incurred in prior years
    - Relative to the average annual MERs for North American Equity Funds
3. **Time and Effort** – Qualitative review.
    - Are you enjoying managing your investments?
    - Do you want to manage more or less of your investments?

A great value proposition would be to outperform the S&P 500 index, net of trading costs and a Sharpe Ratio > 1. A well-designed portfolio of quality assets should require less trades. Both the portfolio and the investor's health stand to benefit.

Summary Thoughts

While avoidance of fees may be a prime motivator, a commission-free trading platform may become our nemesis if it is used to justify over-trading. If annual results are weaker than expected, forensic analysis of our trades might reveal behavior challenges. Alternatively, an investor can just begin anew to adopt better trading habits and a few or all the suggested trading buffers. When it comes to trading, the quality of a trading decision is as important as the quality of assets being traded.

Micro-analyzing our trades and assessing our own value proposition might, together, reveal whether the results of DIY are worth our time, energy and mental health, or whether it's all just an expensive form of entertainment!

***At the Oasis*:**

- In absolute terms, a bigger portfolio does not have to be costlier. Simplicity can be cheaper.
- A Turnover Ratio >50% reflects either low risk tolerance or weak conviction to stock choices.
- Turnover will reduce naturally when stocks are bought for reasons and traded purposefully.
- Proactively setting trades can buffer our emotions and limits our exposure to predatory algorithms.
- Compare year-to-year net performance to your required returns, the pros and a benchmark.
- Underperformance is not a reason to trade more. Renew the search for quality stocks.
- Winning investors trade less and focus more on improving the processes.

"Most traders could make a lot more money if they sat on their hands 50% of the time."

~ *Bill Lipschutz,* principal and director of portfolio management, Hathersage Capital Management