The Sacrilegious Diaries: The Benefits of Turnover

For a fundamental, value-oriented investor, we are reasonably active in the management of our portfolio names. This is by design, and on purpose. With a concentrated, best-ideas-only portfolio, it is imperative that we shed any anchoring biases and constantly challenge our theses. This leads to idea and portfolio turnover.

So too does our insistence on focusing on the negative aspects of any investment case. If we see our sell cases for our favourite long ideas start to strengthen (or buy cases start to weaken) we lose conviction, and this brings expected returns lower.

In this framework, we are attempting to mitigate the behavioural bias that grips us all when faced with positions where the story has changed. As Daniel Kahneman and Amos Tversky pointed out, loss-aversion can lead to silly, and sometimes terrible, decision-making. We've thus tried to develop a firm culture which turns this behavioural weakness into a behavioural strength.

And this leads us to consider that **turnover may not be as bad as everyone thinks it is.**

This philosophy of "best ideas", and concentration within them, drives our continuous review of portfolio exposures as they relate to expected returns, which in turn are driven by a multitude of factors, not the least of which is our fundamental modelling of the firm's financials.


Turnover can be good!

Stocks can move sharply higher or lower. Sometimes this happens without any news other than Mr. Market waking up to a thesis (or overreacting to the wrong one). When the price moves in this manner, it doesn't change what the stock is worth. Consequently, the security's expected return changes. If the drop or increase in expected return is so pronounced that other, portfolio positions subsequently offer lower or higher expected returns, it is incumbent upon us to re-allocate that capital as nimbly and optimally as possible.[1]

But What About Transaction Costs?

There is a general view that trading and transaction costs are bad. They are indeed bad if they don't add value. That said, even if the value from trading is merely a breakeven pursuit after commissions and bid-offer spreads, then there is a debate to be had. Does our familiarity with the companies become stronger when we never ignore them? I know it may be the antithesis of long-term buy-and-hold investing, but is it possible, if not likely, that staying on top of every relevant metric can improve our overall knowledge of the firm?

Moreover, **turnover isn't what it used to be**. **Conventional anti-turnover wisdom is based on a narrative when everyone was paying five cents a share to trade stocks**. Today, institutional investors may pay 1-2 basis points to trade electronically. For a stock that trades at €15, we'll pay one-fifth of one cent in commission, plus two-fifths of a cent bid-offer spread. That's €0.006 per share, which is maybe a small price to pay to debias ourselves, and one that might have a positive expected return if we do it well! Our next post will show how to measure that impact.

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[1] *And this is how we do that: https://www.albertbridgecapital.com/drew-views/2019/5/23/woody-was-right*