

## ***The Sacrilegious Diaries: Measuring the Impact of Portfolio Turnover***

A few weeks ago, we discussed the potential benefits of portfolio and name turnover. This is a quick post on how to measure the impact, and it applies as much to an institutional as a retail investor.

The trick is to decompose our portfolio excess returns into three drivers; stock selection, position sizing, and then dynamic allocation of capital (or trading).

Here is how we, and you can see which of these drives your returns. Firstly, look back to the actual securities you owned at the end of a period (say, a quarter, or a month) and then create an equal weighted portfolio of these names. You can measure the subsequent performance of these names to determine the “buy-and-hold” performance of the portfolio. You can then compare that to the market’s return to determine the returns to “stock selection”.<sup>1</sup>



*Decomposition can be fun, too!*

Then go back to that same starting portfolio and see what *actual* size you were in comparison to the total investment and walk that forward. In other words, don’t equal-weight things, look at your actual weights. Then you can compare your weighted returns to your equal-weighted returns. We call this the returns from “position sizing”.

Then, finally, look at the *actual returns* of your investing (which implicitly is after all commissions). Compare this to your size-weighted portfolio returns to determine any value added from managing (aka trading) your positions in between those measurement periods. We call this the returns to “dynamic capital allocation”.

The fund we manage is called Alpha Europe Long Only, or AELO, and the benchmark against which we measure our returns is the MSCI Europe local currency index. Yours is probably different, but that doesn’t matter. Just use your portfolio and choose the right benchmark to do the same kind of analysis. Aggregating the three drivers of returns noted above, we get the following equation.

$$\begin{array}{c}
 \text{AELO} = \text{MSCI EU} + (\text{Equal-Weighted AELO} - \text{MSCI EU}) + (\text{Size-Weighted AELO} - \text{Equal-Weighted AELO}) + (\text{Actual AELO} - \text{Size-Weighted AELO}) \\
 \underbrace{\hspace{1.5cm}} \quad \underbrace{\hspace{2.5cm}} \quad \underbrace{\hspace{2.5cm}} \quad \underbrace{\hspace{2.5cm}} \\
 \text{Market Impact} \quad \text{Stock Selection} \quad \text{Position Sizing} \quad \text{Dynamic Allocation}
 \end{array}$$

You should try something like this to see where your returns are coming from. You might discover that your trading is terrible and stock selection is great. Or your trading is great but initial position sizing is poor. You might conclude you should switch entirely to a buy-and-hold approach (aka stop trading) or you might see that initial position sizing gives you a leg up.

No matter the answer, we think it is definitely the kind of information that is worth finding out.

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<sup>1</sup> Of course inside those returns you may also find loadings on other factors (e.g. quality, momentum, size, et al) but that is not the subject of this post. This is about the additional impact of position sizing and trading.