

Year End Window Dressing: The Holiday Halo that Hurts

Shirley M. Mueller

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Beauty is in the eye of the beholder

- Margaret Wolfe Hungerford, 1878

When ladies go to a Christmas party, they like to look their best. Others will see them and a good impression is important. In order to accomplish this effect, they might apply special or extra makeup for the event. The idea is to cover a blemish or otherwise enhance their features.

Surprisingly, these women have something in common with financial managers who do the same thing, only in a different way. The latter are not sprucing personally, but instead, executing some last minute beauty repair to the portfolios they administer. The idea is to achieve a more comely report. If there are losers in the portfolio, it looks bad for the supervisor. Therefore, he wants to patch flaws.

One way is to sell off bow-wow stocks or mutual funds. In their place, he buys winners, often at the high price for the year. Still, that overhaul makes his final report look brilliant. He doesn't have underdogs for his clients to look at. Instead, he now has champs. Of course, this result is achieved just before the party, ie, the due date for the end of the year report. This common practice among money managers is called window dressing.

This is a problem for the client, however. Though the money manager might feel better and his report looks sterling, his client should be seeing tin covered with silver. This is why. Just like a woman expends money to buy special makeup to achieve her best look, the selling and buying of stock or mutual funds comes with a price. Trading is expensive and the investor pays the cost.

Stefan Sharkansky found that there was an inverse correlation between turn-over, the selling and buying of stock, and fund performance. For example, smaller capitalization US mutual funds with an average annual turnover of 20% or less had an average annual pretax return of 13.2% or higher. On the other end of the spectrum, those that had an average annual turnover of 210% or higher had an average annual pretax return of 9.25 or lower.

To put this in meaningful terms for the average investor, more turn-over translates into greater investor expense. This puts less money in his/her pocket. If Jane Bright invests one hundred thousand dollars at a 10% return over 30 years in a tax advantaged account with 15% turnover, she will have \$1,598,907 at the end. If her friend, Cindy Dim, executes the same figures, but invests in a managed fund with 75% turnover (5x that of Jane), her ultimate return is \$1,124,290, \$474,617 less.

Unless a client is dogged about details and facts, she never knows she is making less money due to selling and buying stock related to window dressing. Though she can enquire about trading volume for the manager at the end of the year, she may or may not get a straight answer. A better approach might be for the client to look at the actual performance of the stocks in the year end portfolio and compare to some benchmarks. If the latter is better than the manager, there could be a problem. Then, the only options would be confrontation, switching horses, or taking the reins yourself.

Year end window dressing demonstrates once again that though investors with managers are climbing an investment ladder, it could be the wrong ladder for maximum investment success.