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Hyper-Trading Portfolio Deficit Disorder (HTPDD)

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June 2013

"What's the line for?" It was my oldest daughter's first day of work at Murdock Elementary School, the same school I attended as a young boy, and she was curious why there was a line of students in front of the nurse's office. She was told they were waiting to receive their hyperactivity medication. Upon hearing her story, I mentioned that fifty years earlier I was in a similar line. But it was at the end of the day and it was in front of the principal's office. And, likewise, we were waiting for our hyperactivity medicine. However, instead of being a pill administered orally, it was a paddle administered to our behinds.

Attention-deficit disorder (ADD) - later changed to attention deficit-hyperactivity disorder (ADHD) - was introduced into the lexicon in the mid-1980s. Before that, it was simply known as "boys being boys." When I started kindergarten, my mother was worried because I was the classic hyperactive child who couldn't sit still. My favorite movie line of all time is "Can I move?" It was uttered by the Sundance Kid in *Butch Cassidy and the Sundance Kid* and it had to do with the fact that he couldn't shoot straight unless he was allowed to move. I doubt anyone else even noticed that line but, for me, it really hit home.

Mutual fund managers, also, have the urge to move. However, what they are moving is investments around. "Call it hyperactivity," says Economist columnist Buttonwood, "…fund managers, sitting at their desks all day, have the urge to trade…" But, unlike the Sundance Kid, fund managers (and their clients) would be far better off if they *didn't* move. That conclusion was reached by Roger Edelen, Richard Evans, and Gregory Kadlec in their academic paper, *Shedding Light on "Invisible" Costs: Trading Costs and Mutual Fund Performance*." They "…found a strong negative relationship between…trading costs and fund performance."

Most mutual fund investors are not aware that the expense ratio does not capture all the costs of a fund. In fact, it only captures the "visible" costs and those are less than *half* the total costs. Edelen, Evans, and Kadlec explain that "…[mutual] funds incur a host of 'invisible' costs that are less transparent to investors – most notably, the transaction costs associated with implementing changes in portfolio positions." Their research determined that mean trading costs were 1.44% a year, whereas the mean expense ratio was 1.19%.

While it is well established that the expense ratio is one of the few reliable predictors of mutual fund performance, the effect of trading costs on returns had been unclear before Edelen, Evans, and Kadlec published their work. They found that risk-adjusted performance clearly decreased as fund trading costs increased. "The difference in average annual return for funds in the highest and lowest quintiles of aggregate trading cost was -1.78 percentage points."

With average mutual fund trading activity increasing almost seven fold in the last fifty years, hyper-trading portfolio deficit disorder (HTPDD) has reached epidemic proportions. While medicating or paddling your mutual fund managers *is* a consideration, I doubt it would be effective because "traders will be traders." A better option would be to get out of the high cost hyperactively managed fund line and get in line with a low cost, passively managed portfolio of index mutual funds.

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