Turnover ratios and fund quality

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Turnover and Mutual Fund Quality

Mutual fund turnover is calculated as the value of all transactions (buying, selling) divided by two, then divided by a fund's total holdings. Essentially, mutual fund turnover typically measures the replacement of holdings in a mutual fund and is commonly presented to investors as a percentage *over a one year period*. If a fund has 100% turnover, the fund replaces *all* of its holdings over a 12-month period.

You may discover that your mutual fund turnover rate is much higher than you expected. According to Michael Laske, research manager at Morningstar, the average turnover ratio for managed domestic stock funds is 63%, as of Feb. 28, 2019.

Keep in mind that analysts typically disagree on most issues. Nonetheless, it is important to consider the turnover ratio before making any new investment decisions or maintaining your current investments.

As is the case with most technical indicators, the value of turnover in your mutual fund is neither a litmus test for making an investment decision nor an indication of future results. As an investor, you should consider other factors in the context of your mutual fund's turnover rate before making any binding or irreversible decision.

Key Takeaways

- When portfolio managers of mutual funds buy and sell stocks in the market to alter the fund portfolio, it is referred to as 'turnover'.
- While not necessarily a bad thing at the outset, turnover generates transaction fees and potential taxable events for fund investors.
- In general, lower fund turnover rates signal higher quality - but the turnover will depend on the type of fund and its stated investment strategy.
- Growth funds tend to have higher turnover rates as they invest more actively.
- On the other end of the spectrum, index funds should have very low turnover rates as they only trade when the index they're tracking changes composition.

Value Funds

In general, value funds tend to have lower turnover rates, simply by dint of their investment philosophy: find securities that are undervalued relative to the market, hold them until they appreciate to a targeted value, then sell for a respectable gain. Fundamentally, this is a prudent approach and helps minimize your fund's taxable events and expense ratios. Fewer transactions imply lower trading costs and a smaller short-term capital gain. However, simply investing in funds with low turnover rates is not actually an investment strategy, and it's no excuse for poor performance.

Many investors and money managers who espoused this buy-and-hold, low-turnover approach have seen disappointing results. This is particularly true for those who recently saw "value" in financial stocks. Buying them on the cheap and holding them for a long period may have seemed prudent at the time, but, as the chart below illustrates, some mutual funds with low turnovers rates have underperformed the S&P 500 Index's 11.48% annual total return over a five-year period through Feb. 28, 2019.

Symbol	Fund Name	Morningstar Category	Turnover (%)	5-Yr Return (%)
LEXCX	Voya Corporate Leaders Trust Fund Series B	Large Value	0	7.6
CVLVX	Cullen Value Fund Class I	Large Value	2	8.12
AUFFX	Auxier Focus Fund Class Investor	Large Value	3	7.2
RMVIX	RBC Microcap Value Fund Class I	Small Value	5	6.4
QRSVX	Queens Road Small Cap Value Fund	Small Value	6	6.14
HOVLX	Homestead Funds Value Fund	Large Value	7	9.63
QRVLX	Queens Road Value Fund	Large Value	8	8.93
VVIAX	Vanguard Value Index Fund Admiral Shares	Large Value	8	9.81
SLVAX	Columbia Select Large Cap Value Fund Class A	Large Value	9	7.9
HRCVX	Carillon Eagle Growth & Income Fund Class A	Large Value	10	8.75

Source: Morningstar

Growth Funds

Growth funds, on the other hand, tend to have a higher turnover rate, as their money managers are constantly on the lookout for sectors and securities that are the next leaders in their respective industries. The type of management strategy these funds employ is based on finding undervalued stocks, selling high, and making the most of opportunities, which means there can be a lot of buying and selling during any given year. As implied above, a higher turnover rate means the fund will incur more taxable events, and that is likely to eat into its total return. A high turnover ratio may also indicate that the fund's costs are relatively high even for its category. In any case, high-turnover funds really must outperform value funds if all else is equal.

Similarly to the case with value funds, the turnover rate (high, in this case) is only justified when there is a high investment return. Unfortunately, many fund managers appear to be day-trading in disguise. The chart below shows some high-turnover funds with lackluster five-year returns, all of which lag the S&P 500 Index benchmark.

Symbol	Mutual Fund Name	Turnover (%)	Annualized 5 Yr Return (%)
RYWCX	Rydex Small Cap Growth C	834	-8.75
RYGRX	Rydex Large Cap Growth C	450	-10.59
AFUAX	AFBA 5Star Cap Growth Adv	254	-7.27
AFGLX	AFBA 5Star Large Cap Growth I	254	-7.05
VCGAX	AIG Retirement I Growth & Income	238	-6.97
GSXAX	Aberdeen Small Cap A	215	-4.42

Source: Morningstar

Index Funds

If you are investing in an index mutual fund, the passive nature of the security naturally means its turnover ratio should be very low. As their name implies, indexed funds are built to track given indexes, and require almost no hands-on management. Stocks are only added or removed when the underlying index posts a change.

An index fund with a high turnover rate is not being properly managed. Anything over 20 to 30% should be viewed with skepticism or concern.

The Bottom Line

Another consideration for investors when evaluating mutual fund turnover is the type of investment accounts in which the funds are located. Non-retirement accounts are more likely to incur taxable events, and therefore funds with low turnover rates may be more appropriate. Retirement accounts with tax-deferred (401k) or tax-free status (Roth IRA) may be more appropriate for mutual funds with high turnover rates. In any case, investors should do their homework to determine the right mix for them.

There are many online sources for finding the turnover rates of a particular fund. Yahoo! Finance, Morningstar, WSJ.com, and many others provide mutual fund turnover data on almost all mutual funds. Some websites also list the average turnover rate for the category (type of fund).

The turnover rate of your mutual fund is really a measure of the frequency of transactions. In general, when determining whether to purchase a particular mutual fund, investors should analyze the turnover rate in conjunction with several other considerations. No particular fund turnover rate is perfect for your investment portfolio; instead, it should be used as a complimentary decision-making tool. Other indicators, such as expense ratios, load/no-load, management tenure, investment philosophy, and performance are (at least) as important as the turnover rate in helping you make the right investment decisions.