AAII Survey: Why Retail Investors Sell Mutual Funds

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.

However, you may discover that your mutual fund turnover rate is much higher than you expected. The typical managed (active) mutual fund can have an average annual turnover rate in excess of 100%.

The turnover rate of a fund is not necessarily a bad thing, but it does increase your tax bill if the fund is selling stocks with lots of short-term gains and turnover means additional hidden costs that lower your total return. Some mutual fund costs are published, while others are not disclosed. Price impact refers to how high volume affects market price (e.g., a fund selling a large block may drive down the market price of the security). These "invisible costs," such as brokerage commissions, bid-ask spreads and price impact, are harder to estimate. As a result, turnover is an important factor in determining a fund's true costs since transactions costs are not included in a fund's annual expense ratio.

To estimate the trading costs of a mutual fund, many use John Bogle's turnover-based formula for inferring trading costs:

Annual trading costs = 2 x annual turnover x 0.60%.

Thus, a fund with 100% turnover would have estimated annual trading costs of 1.2% (2 x 1.0 x 0.6).

Remember, these are costs that negatively impact your performance that are not reported by the mutual fund.

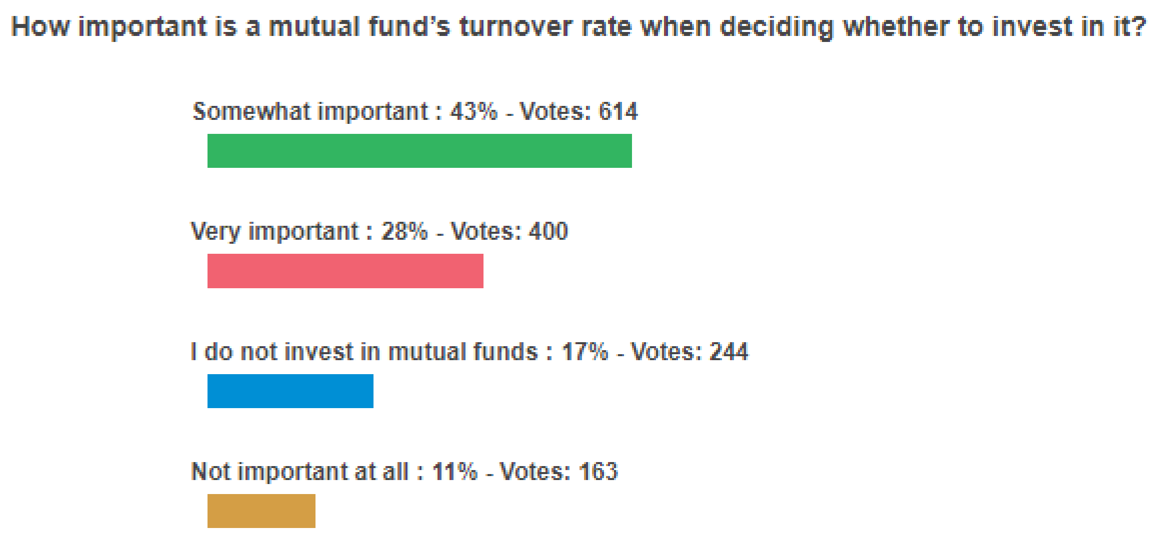
See why keeping an eye on a mutual fund's turnover is so important?

AAII Weekly Survey Question

Seeing how a mutual fund's turnover can impact its returns, we were curious to see if it played a role in the mutual fund selection process. So last week's survey question asked:

How important is a mutuak fund’s turnover rate when deciding to invest in it?

Here are the results:



In all, 1,421 votes were cast.

Less than 50% (43% to be exact) of our readers feel that the turnover rate is somewhat important when selecting a mutual fund. Only 28% say that the turnover rate is very important when deciding whether to invest in a mutual fund.

Surprinsgly, 17% of our readers do not invest in mutual funds and 11% say that the turnover rate of a mutual fund is not at all important when deciding whether to invest in it.

Weekly Special Question

Having discussed one possible consideration when choosing a mutual fund, we were also interested in the other side of the transaction–when to sell. So last week’s special follow-up question asked:

What is your primary reason for <u>selling</u> a mutual fund?

In all, we received 263 responses.

The most-cited reason for selling a mutual fund–mentioned in 38% of the responses–was poor performance. This reason outpaced the next closest response by a 6-to-1 ratio.

With nearly 10% of the responses, the primary reason for selling a mutual fund were tax considerations–taking advantage of capital gains or tax-loss harvesting.

Roughly 8% of responses as to the primary reason for selling a mutual fund dealt with expenses–either fees or trading costs increased or there is a lower-cost alternative available.

Tied for third place (6.5%) for the primary reason for selling a mutual fund were due to portfolio rebalancing and change in the fund manager.

Some of the other top responses we received as to the primary reason for selling a mutual fund were:

- Increased fees
- Better opportunities
- Need to raise cash
- Change in mutual fund asset mix
- Found a better mutual fund

Here is a sampling of what our readers have to say why they sell mutual funds:

- "A change in my investment goals or if I think there is a better place to invest the money."
- "As a momentum/rotation investor I sell as other funds have established higher returns."
- "Change in original investment strategy by the fund"
- "I sell if the fees get too high or for the purposes of reallocation."
- "When its performance lags its peers for three years; when there is a similar fund both in terms of holdings and performance that has a significantly smaller fee; or when the focus of the fund changes and it no longer supports my allocation strategy."

Everybody has an opinion! Why not give us yours? Participate in our weekly member poll, updated every Monday, and see the results online at www.aaii.com/memberquestion.