

## How to Protect My Portfolio Against Russian Aggression...Really?

On an otherwise ordinary Saturday this past February, the President of Ukraine, Viktor Yanukovich, fled Kiev after being ousted by protesters. It seems the only people who reacted faster to his departure than the Russian military were the U.S. financial media. The crisis in Ukraine was barely in its infancy when we noted the following headlines:

- "How to Make the Ukrainian Crisis Work for Your Portfolio"
- "Protect Your Investments From the Crisis in Ukraine"

... and our personal favorite:

- "Buy This Investment to Protect Against Fresh Putin Aggression"

We still react angrily to catchy headlines like these because they demonstrate that media companies seek to profit from the behavioral tendencies of investors at the potential expense of those very same investors' long-term returns. The market rewards discipline and routinely punishes headline chasers, yet it seems as though 99 out of 100 headlines up to derail long-term discipline in favor of reacting to news with an ill-conceived buy or sell.

While we would certainly like to combat these headlines with some of our own, we might have a hard time finding a financial media company willing to publish **"Greedy Financial Media Companies Prey on Investors' Behavioral Instincts."** Therefore, our most productive defense is to continue to educate our clients at every opportunity and protect them from the dangers of equating what they see on television and read on the web with any prudent action in their long-term portfolio.

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We thought we'd shed helpful perspective on the ridiculous Ukraine-related financial headlines by depicting the world stock markets in both 2012 and 2013 while interspersing a timeline of crisis-related headlines.

### World Stock Market Performance - 2012



Source: MSCI. In US dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio. Past performance is not a guarantee of future results.

## World Stock Market Performance - 2013



Source: MSCI. Past performance is not a guarantee of future results. In US dollars. Index is not available for direct investment. Performance does not reflect the expenses associated with management of an actual portfolio.

The above graphs highlight prominent headlines in the context of world stock market performance, as measured by the MSCI All Country World Index. We offer this overlay of headlines not to attempt to explain market returns, but instead to serve as a reminder that investors should view daily events from a longer-term perspective and avoid making investment decisions based on the news.

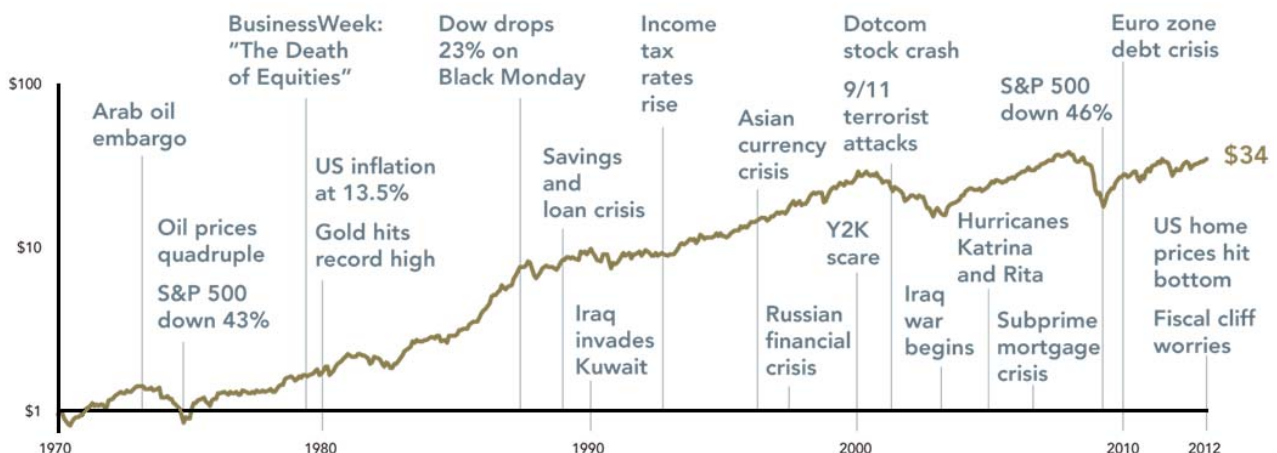
The global headlines show that despite an abundance of negative news, global stocks had exceptional years in 2012 and 2013. However, most investors' investment horizons are significantly in excess of a short-term two-year period.

In case you are worried about your retirement as it relates to things like Crimea, we'd like to offer a long-term vantage

point. Accordingly, presented below is a similar depiction over a 42-year period ending in 2012. The takeaway is that despite dozens of crises along the way, long-term market uptrends are persistent and unassailable.

While our compassion for the Ukrainian people is undiminished, you can rest assured that events there have absolutely nothing to do with your long-term portfolio. As far as your finances are concerned, you can ignore the events there just as you ignored recent crisis-related events in Greece, Cypress, Egypt, Libya, etc., en route to strong returns in 2012 and 2013.

## Markets Have Rewarded Discipline From 1972 to 2012



## Why We Care About Mutual Fund Turnover

As a client of Rockwood Wealth Management you have been (and will continue to be) constantly bombarded with the irrefutable certainty that high-expense mutual funds will underperform low-expense mutual funds over time. However, there is another much lesser-known mutual fund characteristic of investment vehicles, whose presence is persistently indicative of poor long-term performance: turnover.

When the mutual fund manager buys and sells stocks inside the portfolio, the practice is referred to as "turnover." For example, if a fund holds 100 stocks and the manager sells 60 of those stocks during the calendar year, the fund reports turnover of 60%.

It turns out that trading activity can add substantially to a mutual fund's overall cost burden. Equity trading costs, such as brokerage fees, bid-ask spreads, and stock price impact, can be just as large as a fund's stated expense ratio. Internal mutual fund trading costs are not disclosed and they are difficult for the shareholder to observe and measure. They impact a fund's return nonetheless—and the higher these costs, the higher the outperformance hurdle. In equity funds, portfolio turnover can offer a useful proxy for trading costs.

Managers who trade frequently in their futile attempts to add long-term value typically incur greater turnover and higher trading costs.

The University of Chicago's Center for Research in Security Prices recently published results from an academic study (i.e., not a marketing study from some Wall Street brokerage firm) analyzing equity mutual funds and the relationship between turnover and performance. The time periods measured spanned the one-, five- and 10-year periods ending in 2012. To illustrate the results, we've shown the funds ranked into quartiles based on average turnover during the sample period, and performance is compared to their respective benchmarks.

*Managers who trade frequently in their futile attempts to add long-term value typically incur greater turnover and higher trading costs.*

Winner funds are those whose cumulative return over the period exceeded that of their respective benchmark. Loser funds are funds that did not survive the period or whose cumulative return did not exceed their respective benchmark. The chart shows the proportion of winner and loser funds within each turnover quartile. Funds are identified using Lipper fund classification codes and are matched to their respective benchmarks.

## High Trading Costs Make Outperformance Difficult



## The Impact of Costly Turnover

You will note that turnover varies dramatically across equity funds, reflecting many different management styles. For the most recent one-year period (2012), funds in the lowest quartile averaged 14.6% turnover. The average turnover for the highest quartile was 167.5%, more than 10 times higher.

The data shows that higher turnover is a drag on performance: Funds with more turnover have much lower rates of outperformance over longer investment horizons.

For the lowest turnover group, 36% of funds managed to beat their benchmarks over the five-year period. This fraction dropped to just 12% for the funds with the highest turnover.

The moral of the story here is that if we can continue to implement thoughtful long-term strategies using mutual funds with very-low expense ratios and very low turnover, then we are all likely to avoid owning long-term underperforming funds.

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