Alley Company Quarterly Letter
When Less is More

October 14, 2019

Jeff Bezos, founder and CEO of Amazon.com, Inc. (AMZN), in his inaugural letter to public shareholders, proclaimed "*It's all about the long term*." Back in 1997, this statement on the ethos of AMZN as a corporation might not have made the headlines, but fast forward twenty years and that mindset is one of the primary reasons why the company has become a dominant market leader.

Truly focusing on the long term, however, is often times easier said than done. In corporate America, it can mean foregoing short-term profit targets in the pursuit of better long-term market position. And for an investor, it can mean withstanding uncomfortable market volatility to opt for superior long-term results by sticking to a disciplined investment philosophy and financial plan.

The exhibit below depicts how too many investors have been adopting a shorter-term mindset. In the first half of the 20th century, stocks listed on the New York Stock Exchange (NYSE) were routinely held for five years or longer, but holding periods began to plummet in the late 1970s. In recent years, the average holding period for a NYSE-listed stock has dipped to *under one year* as investors have increasingly become "traders" or "renters" of companies as opposed to long-term "owners."

NYSE Average Holding Period by Decade

Source: LPL Financial, NYSE

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What are some of the underlying factors that have driven market participants to hold their investments for shorter periods of time?

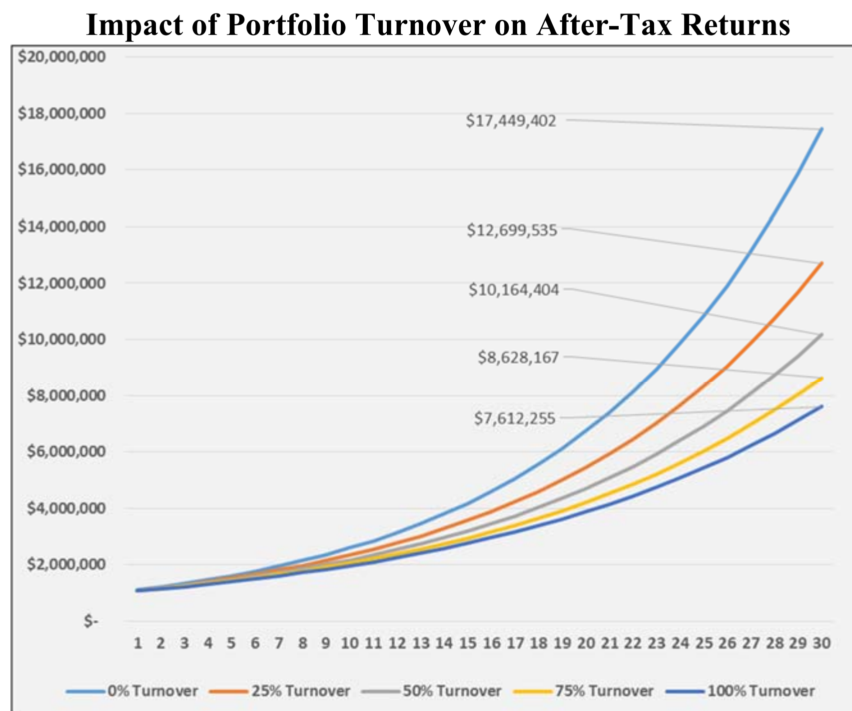
- Technology has clearly played a role as trading today can be done quickly with just the click of a mouse.
- Commission rates have consistently declined over the years and have recently become *free* at many custodians, thus eliminating a deterrent to trading.
- There has been a proliferation of short-term oriented investment vehicles over the past few decades, including hedge funds and algorithmic computer-based trading strategies.
- Financial news programming and instantaneous access to information have magnified the focus on near-term events.

All of these factors feed the impulse to "trade" stocks rather than "invest" in companies.

Short-term thinking and acting on these thoughts can cause "portfolio turnover" to rise which can have a negative impact on *after-tax* investment performance. Portfolio turnover is an industry term that measures trading activity (i.e., how frequently assets are bought and sold) within a portfolio over a twelve month period.[1] For example, a portfolio turnover rate of 100% equates to an average holding period of roughly one year while 10% equates to ten years.

The following exhibit illustrates the hypothetical impact of varying levels of portfolio turnover on after-tax returns for a portfolio with a starting value of $1 million, a holding period of 30 years, and 10% annualized returns. In a taxable portfolio, the axiom "*It's not what you make, it's what you keep that counts!*" is important for investors to contemplate.

Impact of Portfolio Turnover on After-Tax Returns



Source: Alley Company LLC research

While the impulses that drive outsized portfolio turnover can have a detrimental impact on after-tax investment performance, a portfolio turnover rate of zero percent is unrealistic due to normal portfolio management activity. It has been our experience that a range of 10-25% is attainable for investment strategies that take the long view.[2] This underscores the notion that "less is more" when it comes to portfolio turnover.

Certain characteristics of an investment philosophy are conducive to enhancing the power of compounding through lower turnover. The most prominent of these is investing in high quality businesses with leadership positions that enable investors to have a long-term "ownership" mentality. Berkshire Hathaway Vice Chairman, Charlie Munger, had it right when he said, "*The big money is not in the buying and selling, but in the waiting*."

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[1] Portfolio turnover is calculated by taking either the total amount of new securities purchased or sold (whichever is less) over a particular period (typically twelve months), divided by the total asset value of the portfolio or fund being analyzed.

[2] The Alley Company Core Portfolio and the Alley Company Dividend Portfolio have had trailing five year average portfolio turnover rates of 11.74% and 15.37%, respectively.