BANYAN CAPITAL MANAGEMENT

January 21, 2020

Banyan's equity composite was up 34.6% in 2019 compared to the S&P 500's total return of 31.5% (see the enclosed reports for your account's performance). These results were *not* due to a lot of activity in 2019. To the contrary, our results were largely due to good decisions left undisturbed. When there's nothing intelligent to do, and many times there isn't, we do nothing at all.

While seemingly mundane, this is an important point. According to Morningstar, the average turnover ratio of an actively managed U.S. mutual fund is 63%. In other words, the average holding period of a stock in one of these funds is less than 1.6 years. Our numbers tell a different story. The turnover of our equity composite was 11% in 2019, which implies a holding period of 9 years.

Naturally, this raises the question of which is better – high or low turnover. From a performance perspective, the data is fairly clear – low turnover is better.[1] This is intuitive. An equal-weight portfolio of 20 stocks with 63% turnover must be populated with 12-13 new stocks per year. Great investments are rare, however, meaning the average quality of the new investments must be poor. Thus, persistently high turnover is the enemy of high-quality. Less is truly more.

In addition, low turnover has a powerful ancillary benefit – tax efficiency. Imagine, for instance, a fund that can compound at 10%. In 25 years, an undisturbed $100 will be $1,083. If, however, the fund's turnover is 100% and 20% of the gains are sent to Uncle Sam each year, the original $100 will be a mere $685 in 25 years. Clearly, tax "leakage" is a drain investors must consider.

If *low* turnover is better, all else equal, why, then, is *high* turnover so common? Ben Graham, the famed value investor, posed this question to a young fund manager in the early 1970s. After admitting high turnover likely *hurt* his performance, the manager justified his behavior by saying,

> ***"Well, we do get paid to manage the money, . . . [a]nd our employers and clients expect us to be active managers. We're paid to try."*** [2]

---

[1] *See*, *e.g.*, Champagne, Karoui, and Patel, *Portfolio Turnover Activity and Mutual Fund Performance*, Managerial Finance Vol. 44 No. 3 2018, available at: https://www.emerald.com/insight/content/doi/10.1108/MF-01-2017-0003/full/pdf?title=portfolio-turnover-activity-and-mutual-fund-performance (finding, among other things, "frequent churning of a portfolio is value destroying for investors and signals a manager's lack of skill.").

[2] Janet Lowe, *The Rediscovered Benjamin Graham: Selected Writings of the Wall Street Legend*, 1999 (citing an interview published in *Institutional Investor*, April 1974).

Little has changed over the decades. High turnover is likely still attributable to a desire to remain employed rather than a desire to create value for clients. Don't be fooled by this illusion. Value is derived from *quality* decisions, not *more* decisions, and quality *decisions* are the product of quality *thought*. Quality thought, therefore, is the ally of returns; high turnover is the enemy.

Absent necessity, we believe a portfolio should change only when quality thought meets opportunity. The former is an ongoing exercise, but opportunity is beyond our control. Having the discipline to remain patient until both are present is key to ***building permanent wealth***.

Sincerely,

Drew Estes
Partner & Portfolio Manager

Alek Nabulsi
Partner