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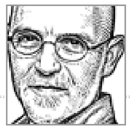
Now That's Performance Art

By JASON ZWEIG



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Do you hear something jingling?

It might not be sleigh bells. It might be billions of pennies cascading into the pockets of money managers, an unwitting gift from clients caught up in the perennial December ritual of "window dressing."

Every year, as Dec. 31 approaches, money managers dump their losers so they don't have to show tainted holdings in their annual reports. But as Jason Zweig explains on The News Hub, the game seems to be changing.

This time every year, most of the market tends to drift into hibernation, but stocks at the top and the bottom of the performance charts often go into overdrive. Many stocks that won big for the first 50 weeks of the year levitate even higher the final week or two. Conversely, bad losers for the year-to-date can take a final pounding as the calendar comes to a close.

Consider tiny Video Display, a maker of electronic equipment (total stock-market value: $44 million). For the year through Dec. 16, the stock was up 38%. This week alone, it added another 4%.

Or take Salesforce.com, the big provider of cloud-computing services (stock-market value: $13.3 billion). The stock was down 19% year-to-date through Dec. 16. This week, it fell another 8%.

Such swings can occur anytime, for many reasons. But they are especially sharp as the calendar winds down and investment managers seek to maximize their own returns—in the form of higher fees.

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Christophe Vorlet

Mutual funds and hedge funds disclose their holdings as of Dec. 31. Whatever the manager sells at any point before 4 p.m. on the final trading day of the year won't show up in that report, while anything the fund holds at the last closing bell will.

Investors then scan the holdings in those Dec. 31 reports to see what's hot and what's not. Funds that report holding big winners attract positive attention, and new cash, from investors. Those with losers on their books won't. And new cash means more money for the managers—especially at hedge funds that generally

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About Jason Zweig

Jason Zweig writes The Intelligent Investor every Saturday for The Wall Street Journal. He is the author of Your Money and Your Brain, on the neuroscience of investing, and the editor of the revised edition of Benjamin Graham's The Intelligent Investor, the classic text that Warren Buffett has described as "by far the best book about investing ever written." Before joining the Journal, Jason was a senior writer for Money magazine and a guest columnist for Time magazine and CNN.com, and he also spent a year studying Middle Eastern history and culture at the Hebrew University in Jerusalem.

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take 2% of total assets and 20% of outperformance as their fee.

In the most innocent window dressing, a money manager simply moves into more stocks that have high "momentum," or hot performance, in the belief that they will keep doing well.

A manager also may systematically purge the portfolio of its worst losers. "You don't want to look like a doofus holding stocks that did poorly," says Felix Meschke, a finance professor at the University of Kansas. "So you get rid of the evidence, like the wife in the old Roald Dahl story ['Lamb to the Slaughter'] who murders her husband with the frozen leg of lamb, then feeds it to the police."

Finally, some managers may be "portfolio pumping." Here's how it works: In the waning minutes of the year's final day, they might enter aggressive bids for a few shares of a stock they already own in bulk—artificially amplifying the value of the entire position.

That can enable hedge funds to confuse current investors and lure in new ones with an ephemeral burst of performance, says Rabih Moussawi, a researcher at the University of Pennsylvania's Wharton School. As a result of this "signal jamming," he says, "they attract much more [new money] than their peers."

Of course, any stock pumped up this way on New Year's Eve is likely to deflate on the day after New Year's—leaving investors barely better off even as the managers earn much fatter fees.

On average, Mr. Moussawi's research shows, stocks widely held by hedge funds pop 0.41% higher than the overall market on the final day of the year and then underperform the average by 0.21% on the first day of January.

Thus, says Vikas Agarwal, a finance professor at Georgia State University, "if you get into a hedge fund in December and then need to get out in January, you're the biggest loser on the planet."

At mutual funds, portfolio pumping—which a decade ago may have exceeded $2 billion a year—appears to have all but disappeared since regulators at the Securities and Exchange Commission cracked down on the practice in 2001 and again in 2008.

But as December winds down, hedge funds may still be pumping winners. "I think just about everybody does it," one hedge-fund manager told me. "Everybody else, I mean," he added with a hasty request for anonymity. "We don't do it."

Meanwhile, mutual funds still are dumping losers.

So, if you have been thinking of buying any stocks that have been on a tear lately, hold your fire; their prices may well be full of hot air next week. However, it probably is a good time to pounce on any beaten-down stocks you like. Funds ditch their losers so ferociously this time of year, says Pankaj Patel, a quantitative analyst at Credit Suisse, that these stocks tend to recover in early January after the selling abates. Mr. Patel says he has institutional clients who put "maybe a 5% portion" of their portfolios into such "reversal candidates" late in the year.

"When a rubber band gets too stretched," he says, "it really bounces back."

— intelligentinvestor@wsj.com; twitter.com/jasonzweigwsj

Corrections & Amplifications

Vikas Agarwal is a finance professor at Georgia State University. An earlier version of this column incorrectly identified him as a finance professor at the Georgia Institute of Technology.

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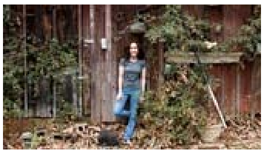

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