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The Truth About 'Window Dressing' — How Some Portfolio Managers Try To Dupe Their Clients At The End Of Every Quarter

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Youtube/ FabAudrey

Hepburn in the Givenchy gown in front of Tiffany's.

At the end of each quarter, some fund managers will buy stocks that did well during the quarter and sell stocks that didn't. This practice is called "window dressing." And it's generally accepted that window dressing occurs (you can find plenty of supporting research here).

Fund managers do this because the top holdings in their portfolios show up in the quarterly statements that get sent to current and prospective clients. If the client sees that outperforming stocks in the portfolio, then they are more likely to be happy.

Obviously, these top holdings misrepresent how the manager actually invested during the period.

With the third quarter coming to a close at the end of this week, some experts have attributed the recent resilience of the stock market as fund managers shifting their assets into stocks. This is plausible because data shows that most fund managers have been underinvested in stocks.

Unfortunately, a fund manager won't tell you that they're window-dressing.

In a paper titled *Window Dressing In Mutual Funds*, Vikas Agrawal, Gerald Gay, and Leng Ling set out to figure out way to detect window-dressing activity by measuring looking at the funds performance and fees. They analyzed actively-managed mutual funds over the period 1984-2008.

Here's what they found:

- Window dressers are 'unskilled' and **perform poorly during the quarter**.
- Window dressers **charge higher fees**, as measured by higher expense ratios.
- Window dressers **underperform in subsequent quarters**.

The authors also note that the delay between the end of the quarter and the time when investors receive their statements is also critical. This period could take up to 60 days.

"In essence, the equilibrium described above suggests that window-dressing managers are taking a bet that will pay off if their performance during the delay period turns out to be good," they write.

Should those top holdings perform well during that delay period, investors are likely to pour more money into the fund.

On the other hand, should those top picks perform poorly during the delay period, investors are more likely to think that the manager was window dressing.

Ultimately, there appears to be ways to detect window-dressing activity. However, the window-dresser is taking a risk should those picks underperform during the delay.