

Funds **talk** – quarterly

Q1 2009

Pound cost averaging

Managing risk in volatile markets

According to ratings agency Standard & Poor's, over a 60 day trading period between October and December 2008, there were 17 days where stocks moved up or down by at least 5%. To put this in perspective, there had only been 17 days of 5% or more swings over the previous 53-year period, between 1955 and 2008.

Source: Standard & Poor's, December 2008.

In volatile stock market conditions, investors are understandably nervous about committing large sums to their portfolios. They can buy today but they know they might see lower prices next month. Lump sum investing can therefore be a nerve-wracking business for some.

One way around this is by investing a little each month. This is known as phased investment, and it benefits from 'pound cost averaging'. Gareth Trainor, Senior Manager of the Fund Monitoring and Governance Team at Scottish Widows helps explain these concepts and considers the advantages and disadvantages of both.



Gareth Trainor

Senior Manager, Fund Monitoring and Governance
Scottish Widows.

What's the big idea?

Concept 1: pound cost averaging

During volatile markets there is a risk that a customer wishing to invest does so at an unfavourably high price. One way to mitigate this is to simply invest regularly, rather than at a single point in time. This means buying units in a fund at various different prices as the market rises and falls. The end result is the customer effectively investing at an average of all of these prices – hence pound cost averaging.

Concept 2: phased investing

Some investors who have a lump sum choose to phase investment into the markets.

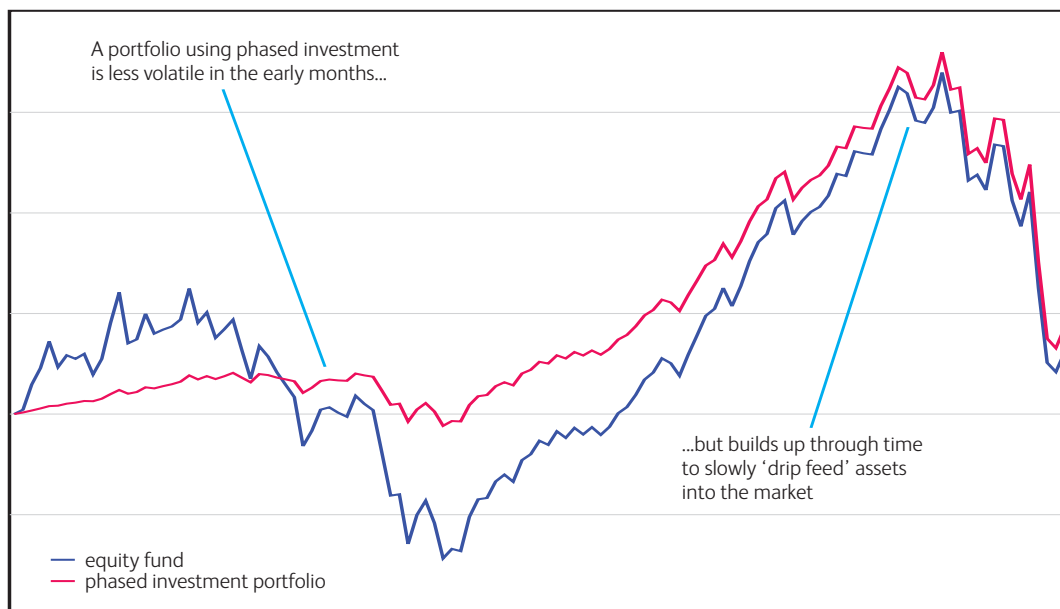
Such investors deposit their lump sum into a cash fund and a regular amount is switched into the investment fund every month over a particular period. This strategy means customers are only exposed to a small amount of risk at the outset and this gradually increases. It's useful for investors who are nervous about investing at the 'wrong time'.

What are the advantages of pound cost averaging and phased investment?

One advantage is that saving regularly is a good discipline for investors. Rather than relying on impulsive decisions or having to remember to set money aside each year, the discipline of investing monthly provides an easy way of saving.

Investing monthly also means customers can be more relaxed about volatility and risk. As they benefit from pound cost averaging they should actually be pleased to see price volatility in the early days of their investments when they don't have significant assets built up. Market falls are an opportunity to buy cheaper units – after all, the ideal investment strategy is to buy low and sell high.

Phased investment also shelters the investor from volatility, as you can see in the graph below. Multiple entry points to the market reduce the risk of picking a day on which prices are high.



Source: Scottish Widows, January 2009.

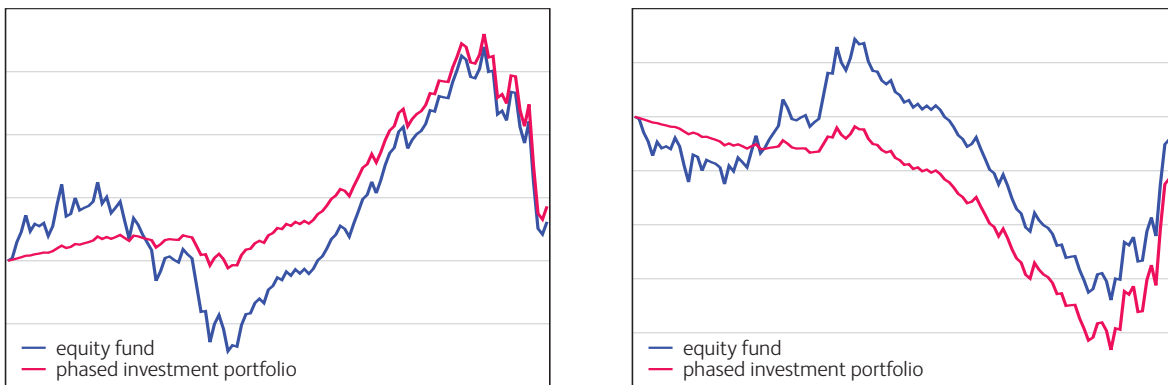
Performance figures are hypothetical and for example purposes only.

Is there a downside?

Although pound cost averaging would seem to make perfect sense, it does have some critics. They argue that if you have a lump sum to invest, it's better to invest it all at once rather than piecemeal over several years. Their argument is that stock markets tend to rise over time, so it does not make sense to leave money out of the market.

Indeed, the biggest downside with a lump sum investment being 'phased' into an investment fund is the risk that the market increases significantly, as most of the investment would be in cash.

Pound cost averaging and phased investing are not 'magic bullets'. They will not provide a better return for you in all types of market. As you can see from the graphs below, investing monthly rather than as a lump sum can both help as well as hinder performance depending on the market conditions.



Source: Scottish Widows, January 2009.

Performance figures are hypothetical and for example purposes only.

So why choose to phase investment?

You can see from the graphs that phasing investment keeps your portfolio's volatility low at the outset and increases gradually. This means you are not going from one extreme (cash) to another (shares) overnight.

Of course, the ideal situation when investing is to have perfect judgement and to be able to predict when markets will rise and when they'll fall. Below we discuss the folly of trying to pick the exact moment to go into the market.

The futility of market timing

It's tempting for investors to become excited about the potential for a bargain and try to time their entry points to the stock market. However, like a shopper buying a new flat screen television in the January sales only to find the price falls even further in February, the excitement can quickly fall flat.

Market timers must have the time to analyse daily events and the skill to act on them. It is telling that few of the best fund managers use market timing to any great extent.

Investment experts widely believe that when it comes to their long-term investments, investors are usually better off if they don't try to guess a good time to invest. The argument for this is stock markets have significantly outperformed building society accounts over the long term.

It's generally accepted that the greatest market gains come close to the greatest market falls. Therefore if you manage to miss the biggest falls, the likelihood is you will also miss the biggest gains.

As such, market timing can be a significant risk in itself. With equities historically outperforming over the long term, a good mantra may be "It's less about timing and more about time in the market".

Conclusions

Lump sum investing

Investing a lump sum in a rising market will provide a better return than regular investments. This is because the full value will increase rather than just the small amount that has been drip fed into the market. On the other hand, in a falling market investing regularly will work better, as not all of the investment will have been committed into the falling market.

Regular investing

Regular saving can reduce the temptation to time the market. It reduces the likelihood of buying at the top and allows investors to spread their investment risk across several buying points instead of one.

Regular investing may not be suitable for all investors as it requires a disciplined approach along with a commitment to continue contributions during periods of market decline. Many investors can't bring themselves to keep investing in a falling market.

Pound cost averaging

The main benefit of pound cost averaging is that it is an easy way to start investing in share-based funds, allowing customers to ignore short-term volatility.

Is now the right time to invest?

There are various opinions, who actually knows? As we have explained above, with phased investment, the current market turmoil is not a reason to avoid investing.

Written by Investment Services, February 2009. The views expressed are those of Gareth Trainor, Senior Manager, Fund Monitoring and Governance at Scottish Widows. Reliance should not be placed on these views when making investment decisions.