

Introduction

'Pound cost averaging' is an investment strategy that can provide regular investors with comfort when markets are particularly volatile.

When you invest a fixed regular amount, the number of shares or units purchased will be higher when the price is low, and lower when the price is high. Someone investing a lump sum will be discouraged when the price of his shares or units falls substantially. However, if a person is investing a fixed amount each month, then when the price falls he will automatically purchase more shares or units each month until the price recovers again.

Like any investment strategy there are situations when this can be useful to an investor and others when it is more likely to reduce the return on your investment.

- You can **only afford to invest monthly** (or at other regular intervals). For the average investor whose goal is to build up a substantial lump sum over the long term for his future security, pound cost averaging is good news. For such an investor, his best strategy is to set up a regular, automatic investment plan and then forget about it. **The plan will effectively handle the pound cost averaging for you.** Provided that you do not require the proceeds of your investment plan within the next five years then you do not have to be overly concerned about what the markets are doing in the short term.
- You **have a lump sum to invest** but because of concern over the markets **you decide to feed this into the market over 6 to 12 months.** If you are concerned that the markets are going to crash, then rather than investing a lump sum **you could feed it into the market in smaller portions over three months, six months or a year.** In a falling market this will provide greater protection for your investment. However, if you are wrong in your view of the future direction of the markets then, of course, following this strategy will provide a poorer return. If your concern is the volatility of the markets then **it may simply be better to invest in a more defensive investment mix.**
- You **have a lump sum to invest** but because of concern over the markets **you decide to feed this into the market over a much longer period than a year.** This is where pound cost averaging starts to lose its appeal. Whatever we may be thinking right now, the long term trend for stock markets is upwards. **Investors are therefore normally better off investing a lump sum as a lump sum** rather than investing smaller amounts over a period of time.

"Dollar cost averaging - also known as a constant dollar plan or in the United Kingdom as pound-cost averaging - is an investing technique intended to reduce exposure to risk associated with making a single large purchase....The premise of dollar cost averaging is that the investor wants to guard against the risk that the market may lose value shortly after making his investment. Therefore, he chooses to spread his investment over a number of periods....In fact, research has shown that investing a lump sum according to these principles generally results in worse performance as compared to investing the entire sum at separate times....While dollar cost averaging can help to limit the downside of a worst-case scenario of an immediate drop in asset value after the lump sum is invested, most market research has shown that such drop-offs are relatively rare compared to the strong emphasis the strategy puts on avoiding them."

Wikipedia

The definitive book on value investing

According to Warren E Buffett, one of the greatest investors in the world, Benjamin Graham's *The Intelligent Investor* is "by far the best book on investing ever written".

In it Graham states "Dollar cost averaging enables you to put a fixed amount of money into an investment at regular intervals. Every week, month, or calendar quarter, you buy more - whether the markets have gone (or are about to go up), down, or sideways."

The Intelligent Investor was first published in America in the early 1950s and Graham carried out various revisions, the last being in 1973 (he died in 1976).

The copy we have was published in 2006 by Collins Business Essentials and is Benjamin Graham's 1973 text updated with extensive new commentary by Jason Zweig.

It will be helpful by way of background to our subject to use some short quotations from the book.

"The Danish philosopher Søren Kierkegaard notes that 'Life can only be understood backwards, but it must be lived forwards.' Looking back, you can always see exactly when you should have invested and when you should have encashed your investments.

In the financial markets hindsight is 20/20 but foresight is blind. For most investors market timing is a practical and emotional impossibility."

The Intelligent Investor by Benjamin Graham

The second quotation refers to John J Raskob (1879-1950) who was a director of Du Pont, the giant chemical company, and chairman of the finance committee at General Motors. He also served as national chairman of the Democratic Party and was the driving force behind the construction of the Empire State Building.

"In 1929 John J Raskob, a General Motors tycoon and well known figure on Wall Street extolled the benefits of dollar cost averaging in an article in the *Ladies' Home Journal* entitled 'Everybody Ought to Be Rich'.

His thesis was that savings of only \$15 per month invested in equities (ie stocks and shares), with dividends reinvested would produce great gains over 20 years.

Now while his optimistic estimate of the gains that could be made from the \$3,600 invested was not achieved, anyone who followed his advice between 1929 and 1948 would have turned their investment into around \$8,500, a return of about 8.0% per annum compound."

The Intelligent Investor by Benjamin Graham

Although inflation would have eaten away much of this gain this was against a background where the DJIA (Dow Jones Industrial Average) was 300 in 1929 and in 1948 had fallen to 177.

"Lucile Tomlinson in her book *Practical Formulas for Successful Investing* published in 1953 states that 'No one has yet discovered any other formula for investing which can be used with so much confidence of ultimate success, regardless of what may happen to security prices as dollar cost averaging.'"

The Intelligent Investor by Benjamin Graham

The effect on risk

Where investments are to be made, say, monthly, it is important to be aware that **you can take a more adventurous risk than you would if investing a lump sum.** This is because you do not have to try and 'outguess the market' - rather you can take advantage of the highs and lows.

As we have already stated, by investing monthly **you automatically buy more units when prices are low** and fewer when prices are high. The result is that **the average cost that you pay for your units over time should be less** than the average price of those units. The only time this would not occur is if the unit price remained constant.

"As the financial markets heave and crash their way up and down day after day, the defensive investor can take control of the chaos. Your very refusal to be active, your renunciation of any pretended ability to predict the future, can become your most powerful weapons. By putting every investment decision on autopilot, you drop any self-delusion that you know where stocks are headed, and you take away the market's power to upset you no matter how bizarrely it bounces."

The Intelligent Investor by Benjamin Graham

Of course, pound cost averaging, is not guaranteed to produce a profit for you or protect against losses in declining markets.

Since pound cost averaging involves continuous investing regardless of fluctuating securities prices, **you should consider your ability to continue purchases through periods of low price levels.**

"Most of the time common stocks are subject to irrational and excessive price fluctuations in both directions as the consequence of the ingrained tendency of most people to speculate or gamble... to give way to hope, fear and greed."

The Intelligent Investor by Benjamin Graham

Returns are linked to actual days

The returns available on unit linked investments depend not only on the investment performance of the funds to which the investment is linked **but on the particular days on which the investment is effected and cashed in.**

- ☞ If the unit prices are low at times during the term of the investment this has no effect on the eventual return of an investor who made a single investment amount.

However, **low prices during the term of an investment can work to the advantage of a regular investor.** This is because his investment will purchase more units when prices are low than he is able to purchase when prices are higher.

- ☞ The investor will receive a better return if unit prices are low for a long period and then rise just before the investment is encashed, than if the unit prices rise to the same eventual height at a consistent gentle growth rate. This is because **units will have been bought on average at a lower cost in the years of low prices.**

"I've found that when the market's going down and you buy funds wisely, at some point in the future you will be happy. You won't get there by reading 'Now is the time to buy.'"

Peter Lynch

Former highly successful fund manager with Fidelity Investments
Author of *One Up on Wall Street* and *Beating the Street*

An example

Let us assume that someone decides to invest **£5,000 a year for 10 years.** We have taken an annual investment as an example because a monthly investment would result in a very much longer calculation. All charges have been ignored for simplicity.

Investment A

Prices rise at a constant rate for 10 years from 100p to 190p

Beginning of Year	Investment £	Unit Price p	No of Units Purchased
1	5,000	100	5,000
2	5,000	110	4,545
3	5,000	120	4,167
4	5,000	130	3,846
5	5,000	140	3,571
6	5,000	150	3,333
7	5,000	160	3,125
8	5,000	170	2,941
9	5,000	180	2,778
10	5,000	190	2,632
Total Units Purchased			35,938
Total Unit Value = 35,938 x 190p = £68,282			

The investor has made a good return. However, the pattern of the following investment is much more realistic than the constantly increasing unit price.

Investment B

Prices fluctuate, going down and up for 10 years between 100p and 190p

Beginning of Year	Investment £	Unit Price p	No of Units Purchased
1	5,000	100	5,000
2	5,000	60	8,333
3	5,000	90	5,555
4	5,000	110	4,545
5	5,000	130	3,846
6	5,000	140	3,571
7	5,000	90	5,555
8	5,000	110	4,545
9	5,000	150	3,333
10	5,000	190	2,631
Total Units Purchased			46,914
Total Unit Value = 46,914 x 190p = £89,136			

The investor has made an even better return and rather than suffering as a result of the volatility in the unit price, he has gained because **he purchased a much higher number of units overall.**

Please note, however, that an investor who was able to **invest a £50,000 lump sum at the outset would have received even more,** ie $50,000 \times 190p = £95,000.$

Of course, in such simplistic examples we cannot allow for the effects of inflation nor the returns someone with a lump sum would have gained had he left it on deposit and transferred £5,000 into this investment once a year.

The purpose is simply to show that **regular long term investors need have little fear of volatile markets.**

Practical Applications

Pound cost averaging can be **used for any investment or pension plan** which allows for regular investments.

For example:

- It can be used to **build up a portfolio of investment funds**. This should ideally be done via a fund platform such as a wrap or fund supermarket which will give you the benefits of a very wide range of funds and administrative simplicity. We would be happy to arrange this for you via the Nucleus Wrap or the Cofunds Fund Supermarket.
- It can be used to **build up a portfolio** of funds within a **Stocks and Shares ISA**. This should again ideally be done via a fund platform such as a wrap or fund supermarket and we would be happy to arrange this for you via the Nucleus Wrap or the Cofunds Fund Supermarket.
- It can be used to build up a pension fund within a **personal pension plan** or **stakeholder pension plan**.

"The financial markets generally are unpredictable. So that one has to have different scenarios. The idea that you can actually predict what's going to happen contradicts my way of looking at the market."

George Soros
Billionaire Fund Manager and Philanthropist

Risk Factors

- Past performance is neither a guide to, nor a guarantee of, future returns.
- The value of your investment is not guaranteed and can go down as well as up, and you may not get back the amount you originally invested.
- The value of units in collective investment schemes that use derivatives such as options and futures may under certain circumstances be more volatile than non-derivative schemes and therefore upon withdrawal you may receive back substantially less than the full amount invested. In extreme circumstances you may receive nothing back.
- Pound cost averaging is not guaranteed to produce a profit for you or protect against losses in declining markets.
- As pound cost averaging involves continuous investing regardless of fluctuating securities prices, you should consider your ability to continue purchases through periods of low price levels.

Please note that **this information does not constitute personal advice** and should not be treated as a substitute for specific advice based on your circumstances. This Guide is simply designed as an introduction for you to pound cost averaging. It cannot cover every possible aspect of this investment technique and is not meant to be exhaustive.

If you are in any doubt as to whether the use of pound cost averaging is suitable for you, then **you should discuss the matter with a suitably qualified independent financial adviser** such as ourselves.

For Personal Advice

If you would like to discuss whether an investment using pound cost averaging might be appropriate for you please ask your usual Arch adviser in the first instance or contact us via one of the following:

Tel: **0845 3700 661**
Email: **enquiries@arch-fp.co.uk**
Online: **www.arch-fp.co.uk**

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