PHASING IN AS AN INVESTMENT STRATEGY

Since 2007, our company has phased in all lump sums (especially for retirees) for our clients. New research from Vanguard shows that this strategy will reduce investment risk but might also limit maximum returns for investors, even if the investment term is 10 years or longer. Does the research change my mind? No, or possibly…

INITIAL PRICE OF YOUR INVESTMENT IS CRITICAL

There is a lot of research that shows how your potential investment returns can be severely impacted if you experience a dramatic loss in the early stages of your investment's life. This is especially true if you are recently retired and take the decision to invest 100% of your capital immediately into your desired portfolio. We have recently met a retiree who invested 100% of his living annuity into a balanced portfolio in March 2008. He had a good start to his investment performance but then the market crashed in late 2008 and caused a 20% loss in his portfolio. During the market crash, he still needed to draw his income and inflation was eroding the value of his money. This combination of events resulted in long term losses to his capital from which he is unlikely to recover unless the stock market jumps dramatically in the next few years.

In contrast, the lady I met in early 2008 who phased in her retirement fund over 12 months, experienced no losses in the first year of her retirement although her growth was limited over the period. The effect of this phasing strategy meant that she was buying investments during the entire market crash of late 2008 and early 2009. The fact that her capital was being slowly invested into the markets during a very rocky time, gave her some comfort which meant a low-stress first year of retirement. Her portfolio has subsequently grown by more than 11% per year when the inflation rate has been 6% which is largely due to the low prices she initialy paid for her investments.

PHASING-IN HAS A COST

Vanguard published a report in July 2012 called "Dollar cost averaging just means taking risk later" where they studied the long term impact of phasing your lump sum investments into the market over many different periods. They showed that when an investment is immediately invested into the desired portfolio (lump sum) there is a 66% chance that it will outperform a portfolio which is phased in over 12 months. This applies to balanced portfolios, 100% equity portfolios and 100% bond portfolios in the US, UK and Australian markets. Most gamblers would tell you that betting your money on something that has a 66% chance of winning, is considered a low risk bet. For experienced investors who do not need to access their capital for at least five years, it makes sense to invest all your money at once. You will get a slighter better return in most market conditions. This is especially true if you invest in a rising market. It is important to note that none of us can predict what the markets will do in future, so you cannot rely on the fact that the market has recently climbed as an indication that it will continue to do so. If you invest during in a declining market, it is very likley that phasing in will work in your favour.

WHAT SHOULD YOU DO WITH YOUR LUMP SUMS?

If you are investing in very volatile stock market conditions or if you are not an experienced investor, it is advisable to phase your lump sum over 12 months. This has the benefit of being less stressful and enabling you to buy great assets at a discount. In addition, you will be less tempted to sell your investments and remain in cash until, "things get better".