TUDOR FRANKLIN
independent financial advice

MARCH 2022

GUIDE TO

POUND COST AVERAGING

Smoothing out market volatility

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So you have a lump sum to invest. What now? Do you invest it all at once or bit by bit? Will soaring inflation, rising interest rates and further supply chain disruption fuel market volatility this year and impact on your lump sum?

Fear and worry are understandable, but trying to second-guess the impact of events – or even attempting to make a bet on them – rarely pays off and understandably can deter some people from investing.

Stay focused on your investment goals

Global stock markets, as we've seen in recent times, can be unpredictable and highly volatile. They move frequently – and sometimes sharply – in both directions. This is why it's important to take a long-term view (typically ten years or more) and remember your reasons for investing in the first place.

Investors need to be prepared to view the downturns simply as part of a long-term investment strategy and stay focused on their investment goals.

Avoidance of trying to second-guess market movements

Of course, it's also important to remember that past performance is not a guide to what might happen in the future, and the value of your investments can go down as well as up. Market conditions, investor sentiment and other factors will cause prices to rise and fall – and this in turn affects the value of the capital that was used to purchase them.

Another option for more risk-averse investors over the long term is to save regular amounts, which enables the avoidance of trying to second-guess market movements. This method of investing is called 'pound cost averaging'. The idea is to provide some protection against the possibility of the market dropping sharply shortly after the money is invested. You are effectively drip-feeding money into shares or units on a regular basis rather than committing a single larger lump sum, and it works by smoothing market volatility.

Reduce the risk of buying in highly volatile market conditions

Pound cost averaging is based on the principle that when markets are low, you acquire more for your money, and when markets are high, you acquire less. It is most often used with equity-based investments rather than bonds or fixed income assets that tend to be less volatile. The concept can apply to regular monthly investing as well as spreading the investment of a large lump sum over a period of time.

Regular or phased investments can also reduce the risk of buying on the wrong day and in highly volatile market conditions – as we've been experiencing – and it could mean

that investors are able to purchase more units. This type of investing can more accurately be thought of as a series of lump sum investments, since the entire contribution is invested each period. Phasing can be achieved via an automated phasing facility or by instructions to switch from one fund to another over a period of time specified by the investor.

Instilling investment discipline no matter what the market is doing

To give you an example, one way to do this is with a lump sum that you'd prefer to invest gradually – for example, by taking £500,000 and investing £50,000 each month for ten months. Alternatively, you could pound cost average on an open-ended basis by investing, say, £5,000 every month.

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This principle means that you invest no matter what the market is doing. Pound cost averaging can also help investors limit losses, while instilling a sense of investment discipline and ensuring that investors are buying at ever-lower prices in down markets.

Drip-feeding a lump sum investment into funds in regular amounts

Regular saving and investing is a highly effective way to benefit from pound cost averaging, and instills a savings habit by committing you to make regular contributions. Regular saving is especially useful for investors who want to put away a little each month.

Investors with an established portfolio might also use this type of approach to build exposure a little at a time to higher-risk areas of a particular market. The same strategy can be used by lump sum investors too. Most fund management companies will give you the option of drip-feeding your lump sum investment into funds in regular amounts. By effectively spreading your investment by making smaller contributions on a regular basis, you could help to average out the price you pay for market volatility.

Taking advantage of market down days with regular long-term saving

Investment professionals often say that the secret of good portfolio management is a simple one – market timing. Namely, to buy more on the days when the market goes down, and to sell on the days when the market rises. As an individual investor, it is likely that you may find it more difficult to make money through market timing. However, you could take advantage of market down days if you save regularly by taking advantage of pound cost averaging.

Historically, the overall direction of developed stock markets is a relentless and continual rise in value over the very long term, punctuated by falls. It's important not to let current global uncertainties affect your financial planning for the years ahead. Individuals who stop their investment planning, particularly during market downturns, can often miss out on opportunities to invest at lower prices.

Impact on global markets over the coming months

It's likely that the coronavirus will still continue to have an impact on markets over the coming months, and even years. However, major events causing global markets to fall, particularly in the short term, is something we've seen time and time again. And it doesn't mean that markets won't recover, so try not to worry too much.

History shows again and again that the ups and downs of different types of market conditions are part and parcel of investing, and there have been many times in the past when events have caused short-term corrections. ■

SPEAK TO US FIRST BEFORE MAKING ANY DECISIONS

Pound cost averaging enables you to create a more disciplined investment approach and removes some of the worry about making lump sum investments at the wrong time. It also enables you to take advantage of market volatility, and although it is not guaranteed to be the best strategy, it does offer a low maintenance and lower stress approach. To discuss your investment goals or if you require information, please contact us.

LOOKING TO CREATE A MORE DISCIPLINED INVESTMENT APPROACH?

When it comes to investing your money, making regular investments can offer more benefits than investing a lump sum. It may be that you don't have a lump sum to invest, but you can afford to commit a regular monthly sum.

To discuss your plans for the future and how we can help, please contact us.

Published by Goldmine Media Limited, Basepoint Business & Innovation Centre, 110 Butterfield Green Road, Luton, LU2 8DL.

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