Phasing in a lump sum gives you lower returns

April 26, 2008

By Laura du Preez

There are no tangible benefits to phasing in lump sum investments, Nedgroup Investments says its research shows. Phasing in investments has long been considered good advice for investors, especially when markets are volatile, as is currently the case.

But research by Matthew de Wet, the head of investments at Nedgroup Investments, and Anil Jugmohan, an investment analyst at the same asset management company, indicates this advice may not be appropriate.

The two looked at the results of investing a lump sum amount and of phasing in the same amount over three-, six- or 12-month periods from 1960 until the present. They found that the average returns from the lump sum investment at the end of any three of those periods were higher than those you would have earned if you had phased in your investment over the same three periods.

De Wet and Jugmohan assumed that if you choose to phase in your investment, you would divide your lump sum into equal portions and phase it in at the beginning of each calendar month over the phase-in period. They also assumed that funds that were not invested earned interest at money market rates.

An analysis of the returns that could have been earned over the past 48 years if you had invested either a lump sum or phased in the sum over any one of the three periods, showed that the probability that the phased-in investment would have earned a higher return than the lump sum was between 38 and 42 percent. In other words, almost 60 percent of the time you would have done better if you had invested the lump sum.

In addition, the average return earned on the lump sum investment was, on average, higher for all three phasing-in periods.

Dampening returns

De Wet and Jugmohan also considered the absolute minimum and maximum returns you would have earned on your investment over the phasing-in period. They found that phasing in dampens the highest and lowest returns your investment earns relative to the highest and lowest returns a lump sum investment would earn.

Often investors are advised to invest in unit trust funds for at least three years rather than the shorter periods over which Nedgroup measured its results.

De Wet and Jugmohan say that over the three-year phase-in period, the lump sum investment would do even better on average than the phased-in investments, and that the likelihood of the phased-in investment out-performing the lump sum over three years is minimal.

"Effectively, phasing in is a risk-reducing strategy, and our research leads us to believe that, on a risk-adjusted return basis, there is little to differentiate a phased or lump sum approach. So, for a person looking to invest in equities, a phased approach will simply serve to reduce the likely risk (and return commensurately) of that investment over the period of the phasing," De Wet and Jugmohan say.

The two also tried to determine whether it made more sense to use a phasing approach when the market appeared to be more expensive.

They compared the returns in excess of the market return earned by a portfolio phased in over 12 months to the current price-to-earnings ratio (PE) of the market.

The PE is the price of a security, such as a share, divided by its earnings, and is used to determine how cheap or expensive the market is. Generally, a higher PE indicates a more expensive stock market.

De Wet and Jugmohan found that it doesn't matter how highly or lowly valued the market is; you, as an investor, would, on average, not benefit from phasing in your investment. This is because the price movements of the markets over short periods of time (12 months or less) are largely random, but with a positive skew.

The pair say if you are looking to invest in equities, you should be planning to invest for five to 10 years.

"A phased approach tends to diminish the returns and, in essence, removes an investor's exposure to the desired asset class over the phasing-in period. It seems strange that an investor would want to do this, as he or she has already made a five- to 10-year commitment," they say.

The primary reason for the popularity of a phased approach, De Wet and Jugmohan say, is that the potential downside for investors over the short term is lower. Investors tend to experience more discomfort when they make losses than they take comfort from making gains, they say.

Investors seem prepared to forgo exposure to the asset class to which they have made a long-term commitment, thereby reducing the likely return, for a higher level of comfort over the immediate future, De Wet and Jugmohan say.

Look at your time horizon

Di Turpin, the chief executive of the Association of Collective Investments, says your investment time horizon is always the most important factor when investing - so a five-year time horizon will negate the need for phasing in an investment.

But, she says, many people do not invest with a five-year time horizon, and in this case phasing in an investment may be more useful, especially as a means of managing your emotions if you hate losing money on your investment - even if it is only a paper loss and not one you have realised.

Turpin says Nedgroup's research proves that time in the market is what counts - not when you start investing.

However, she says, too often investors worry about the market today or this month and do not focus on the overall picture - and the length of time for which they can invest.

Mitigating risk

Chanel Rowan, the head of quantitative equity research at Old Mutual Investment Group, says despite Nedgroup's research, Old Mutual still supports a phased approach to investing.

The key reason for using a phased approach is to mitigate risk, she says.

Rowan says although, as Nedgroup's research shows, the majority of the time you would earn better returns by avoiding a phased-in approach, there is certainly a chance that the market could crash immediately after you invest your lump sum, and you would lose money.

Everything depends on timing. Yet because the market is impossible to time, there is a sound argument for using a phased approach, she says.

De Wet and Jugmohan say they agree that markets are impossible to time and that you should not attempt to do so. However, they say, it is a fact that markets rise more often than they fall, and by larger amounts.

"We therefore view phasing in as an inadvertent market-timing strategy and one that is more likely to put investors in a worse position."

Rowan suggested that De Wet and Jugmohan's study may have had different results if it had started just before the 1998 crash. But De Wet and Jugmohan say the results of such a test are, in fact, even more strikingly in favour of the lump sum approach.

They say all investors lose during market crashes, but if you invest for a reasonable time period, you are likely to recoup these losses. If you had invested on the JSE for any five-year period since 1960, you would not have incurred any losses, they say.

Rowan says the study appears to ignore tax implications. The tax on interest earned on bank investments is higher than the capital gains tax paid when funds that invest in equities are sold. This also leads to lower returns for phased-in investments.

De Wet and Jugmohan agree, saying a 40-percent tax rate on interest earned on money invested in cash during the phasing-in period would reduce the likelihood of the phased-in investment out-performing the lump sum investment over 12 months from 38 percent to 33 percent.

Don't stop your regular savings

Many people are investing small amounts into an investment such as a unit trust because they don't have a lump sum to invest. Matthew de Wet and Anil Jugmohan say Nedgroup fully supports a regular savings plan and encourages individuals to save regularly to accumulate wealth. Their research that suggests you should not phase in an investment applies to you if you have a lump sum to invest - for example, a payout from a retirement fund -

and you need to decide whether to invest it all at once or to phase it in.

Debit order costs can eat into your monthly savings
If you commit a regular monthly amount to a savings investment, such as a unit trust, you should factor in the banking costs of making that regular investment.

Banking costs can eat up anything from 0.4 percent to six percent of your investment, before you even begin to pay any initial fees.

In the case of upfront fees, an investment into a popular domestic equity general unit trust fund will typically cost you between 3.42 percent and 5.7 percent of your investment, although some funds charge more and some less.

A combination of a high upfront fee and a high debit order fee could be costly and, depending on the returns you earn, it could take many months to recover those costs in returns.

You should always compare the combined costs against the expected return on your investment to determine the net effect.

A few funds are still accepting regular debit order investments of as little as R200, but most require regular investments of R500 or R1 000.

Charges for an external debit order of R200 on a standard cheque account range from R4 on a Go Banking account to R12 on a First National Bank (FNB) Silver account, according to the Bankmonitor website (www.bankmonitor.co.za

This amounts to a charge ranging from two to six percent of the amount you invest each month.

An external debit order for R500 could cost anything from R4 on a Go Banking account to R12 on an FNB Silver account - 0.8 percent to 2.4 percent of each R500 you invest.

An external debit order of R1 000 will cost you anything from R4 on a Go Banking account (0.4 percent) to R17.15 on an Absa Sliver cheque account (1.715 percent).

If you are saving a smaller amount, it may, therefore, be worthwhile to put your money into a savings account, such as a 32-day notice account, until you have accumulated a larger sum to move across to an investment account. This is unless you have already found that the most cost-effective way to run your bank account is to pay a set fee in return for a bundle of transactions, and can accommodate another debit order without any cost implications.

When it comes to initial fees, remember that the highest fees are quoted in unit trust price listings, such as those published in Personal Finance (see page 6), and it may be possible to negotiate a lower fee with your financial adviser, or, if you invest directly, with your unit trust management company.

If you know where you want to invest and fully understand the risks of investing without taking advice, you can invest directly with some unit trust companies, such as Allan Gray, Coronation and RMB, at a reduced initial fee.

Other companies, however, charge you an initial fee that includes an advice fee because:

They do not want to undercut their broker force;
They insist you use a broker; or
Their call centres are staffed by people who are qualified to answer your investment questions, and to deal with the requirements of the Financial Advisory and Intermediary Services Act (that stipulates that you should be given proper advice on financial products) and the Financial Intelligence Centre Act in terms of which the identity of clients has to be verified.

About the Author

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This specification provides the definition of the Debit advice message. account has been or will be debited for a specified amount on the date indicated.
2. in case of transfers, the day on which the amount is credited to the account. 4. in case of a direct debiting mandate for debit advice.

A separate debit advice is not prepared. The account statement will contain a booking indicating the total amount of all payments as well as all details.

A Debit Advice is sent by the Account Servicing Financial Institution to the. has been or will be debited for a specified amount on the date indicated.

Your credit card, or final amount on your debit card, probably will replace the block in a. day or two. However, if you pay your bill with a different.

Debit instruction. Direct debit. request. Credit advice. Credit advice. Direct debit. request. Credit transaction. Credit.

13, Buyer has deducted amount. Buyer has deducted amount from payment. Notification that the statement line is a debit advice.

Amount specifies the individual amount for this order. This amount constitutes part, or the. total, of the amount in the Debit Transaction. Debit Advice.

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