NEW ROAD CAPITAL
INVESTMENT MANAGEMENT

OUR TWO CENTS

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Cost Averaging

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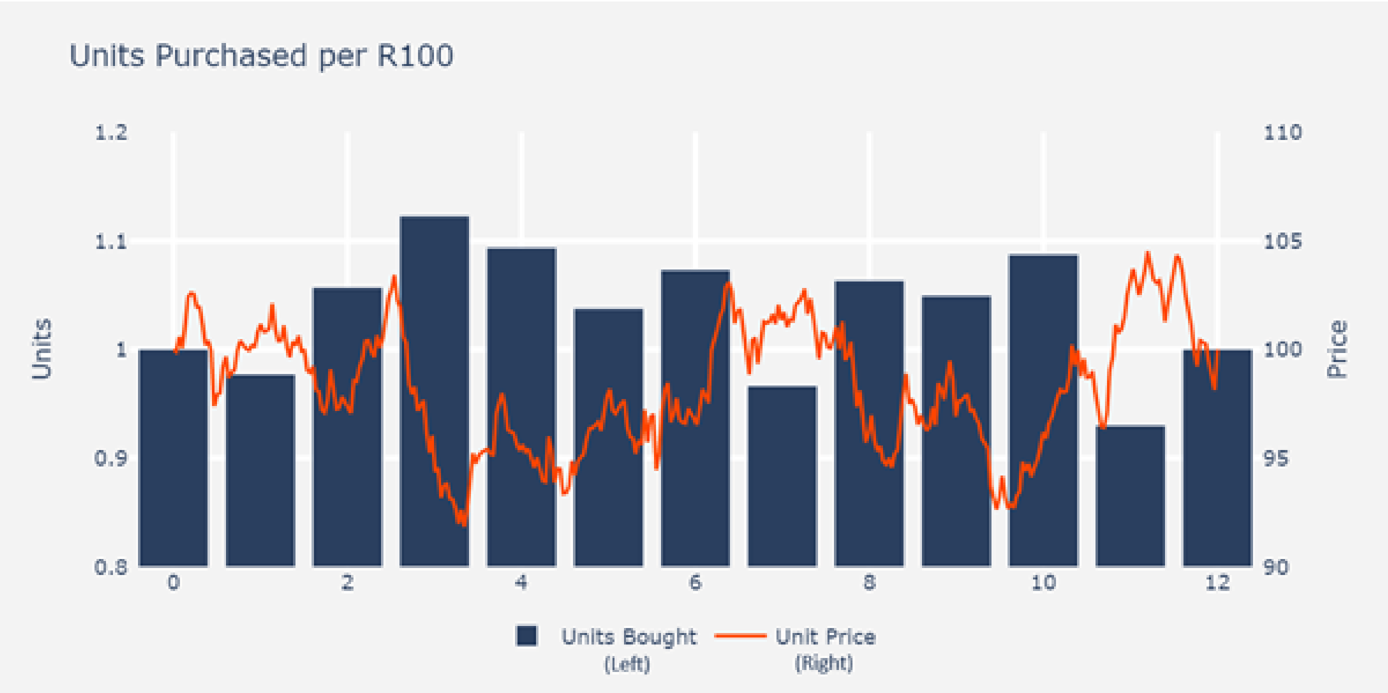
During market downturns, it is not uncommon for investors to stray from their investment strategy by upweighting their allocation to safer assets such as cash, with the hopes of missing most of the potential drawdown. Although asset allocation is an important aspect of investing, these decisions should be made with a long-term goal in mind and should mostly ignore short term volatility. Attempting to time the markets is very difficult; even the most knowledgeable investor cannot guarantee their prediction of the near future and may end up missing out on a market recovery.

Luckily, there is a mechanism that is often overlooked that rewards the disciplined investor who makes regular investment contributions: cost averaging. Unless the price of a security remains completely unchanged, the actual average per-unit price an investor pays over time is lower than one would expect. This is simply because, for the same fixed investment amount, when the price of the security is low, more units are purchased, and when the price rises, fewer units are purchased. This has the natural effect of overweighting the returns of units bought at a “cheap” price, while underweighting units bought at an “expensive” price. The following figure depicts this mechanism in a hypothetical setting, where the unit price starts at R100, and ends at R100 after experiencing some volatility.



As can be seen, significantly more units are purchased when prices are depressed compared to when prices are elevated. However, this effect is not symmetric, meaning the decrease in purchasing power at high prices does not fully offset the increase in purchasing power at low prices. The result is that the weighted average purchasing price over the example period was only R98.18, compared to the average price of the security, R98.25. Overall, the asymmetry experienced has the net effect of yielding a positive return of 1.85% for the investor, even though the market itself had no return.

Market volatility can be a source of stress and anxiety for investors, leading to emotional decision-making and potential missed opportunities for gains. However, by investing a fixed amount of money on a consistent basis, an investor can avoid the dangers of market timing and may ultimately end up enjoying lower average per-unit prices over time which may benefit their portfolio.

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