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The law of averaging

Merryn Somerset Webb Investing

This year's most frequently asked question has been: "I've sold my house – how do I invest the money?"

Luckily, the answer to this one (unlike most of the questions I am asked) is very easy. If you are intending, at any point, to buy another house, you can't invest your cash pile.

All you can do is put it in a savings account and leave it there. Which one? That's easy, too. Unless you want to spend hours every month moving your money around, it has to be the Investec High 5 account (which offers interest equal to the average paid out by the five top accounts on the market and updates its rates accordingly every week). You have to put in at least £25,000 and give three months' notice of a withdrawal but neither of those should be deal breakers for today's would-be homebuyers – just make sure you give notice to withdraw the money a few months before you start househunting in earnest.

But what if you aren't buying another house and you just have a lump sum that you want to invest? Then what? Conventional wisdom has a very clear answer for you: pound (or dollar) cost averaging – a strategy that is supposed to take the worry out of investing.

Instead of shovelling all your money into the market in one go, you invest a fixed amount into the market every month until it is all gone. That way, you don't need to worry about the absolute level of the market. If it falls, you get to buy units in your chosen investments at a lower price. If it rises, you get your share of the spoils. Sounds good, right? But does it actually work?

Not if you want to make the best returns possible. A note just out from the CFA Institute, written by analysts at Bernstein Global Wealth Management, points out that, during the last 80 years, the US stock market has gone up 70 per cent of the time. That means that the odds of the market outperforming cash are always high which, in turn, means that one should be fully invested most of the time.

Gregory Singer and Ted Mann, the authors, point out that, based on rolling 12-month periods since 1926, the average annual gain on the US market has been around 12 per cent. Over the same period, sitting on cash would have made you 4 per cent and dollar cost averaging around 8 per cent. Holding cash turned out to be a pretty bad strategy all round, but a really bad one in the year after a down year for the market.

During those years, being investing all at once returned an average of 15 per cent but holding cash returned only 3 per cent, some 12 percentage points less. There's a statistic I wish I'd had to hand at the end of last year.

Still, just because the numbers suggest that lump sum investing should be done in one go, that doesn't mean it must be. A market that goes up 70 per cent of the time goes down 30 per cent of the time. So, however historically unlikely the CFA Institute says it might be that you will lose money in the end, who wants to chuck all their cash into the risk of a crash – as some might be doing today?

Let's not forget that study after study has shown that that most of us fear losses more than we crave gains. With that in mind, we should be looking at pound cost averaging as a type of insurance against market losses.

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Further analysis by Singer and Mann (you can find the full paper in the Private Wealth section at www.cfainstitute.org) suggests that, since 1926 in poor markets, averaging has resulted in the investor ending up 11 per cent richer than had he invested all at once. In "typical markets", he has historically ended up 2.9 per cent poorer over the first year and in strong markets a nasty 13 per cent poorer.

So, clearly, this insurance doesn't come cheap. But, for the risk averse I'd say it is worth it. And, for most of us, it probably beats market-timing strategies: market entry and exit points are easy to see in hindsight but do you know anyone who actually got out of the market two years ago and went back in this March?

So there you have it. If you've sold a house or been left a fortune, the statistics are telling you that the safest thing you can do is to start staging it into the market right now.

One final point though: given that markets are more prone to rise than to fall, the longer you take to average in, the higher the cost. So, if you are going to do it, you need to do it reasonably fast: six months is apparently the optimum period of time to take.

The market timer in me is terrified by this prospect – six months from now is exactly when I expect the stock market to be much lower than it is now. But you may want to bet on the statistics over my bearishness.

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