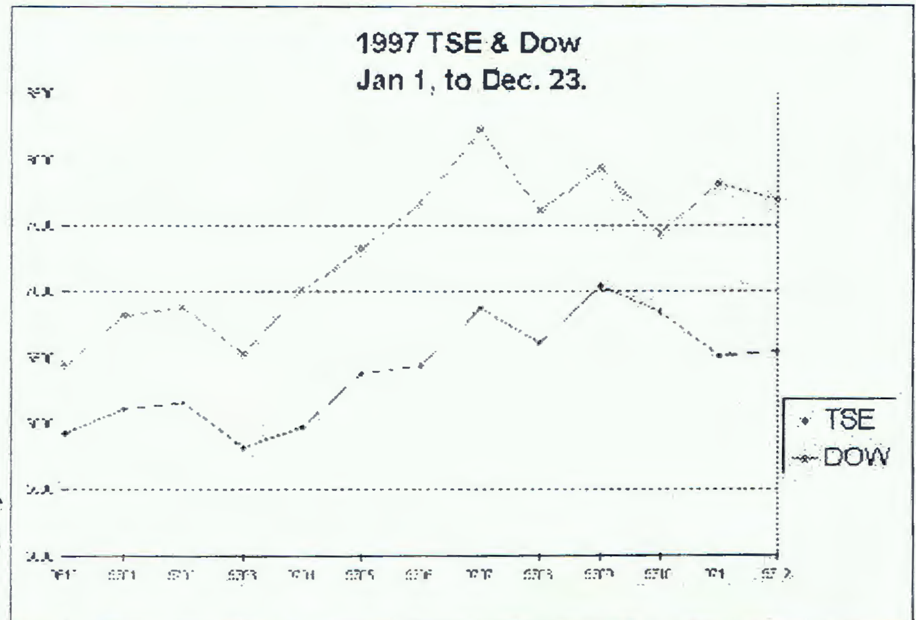
The Importance of Averaging

There is a tendency to want to invest more when markets are good and less when they are bad. Unfortunately, this is the opposite of what you should be doing, as investing during good markets usually means buying high. If we knew where the markets were going we could make a fortune. We would invest heavily when markets are low and withdraw everything at the peaks. Since we do not know the future we cannot do this, but we can spread our risks by averaging into the market.

Averaging into the market simply means investing on a regular basis, regardless of what the market is doing. The regular basis can be monthly, quarterly, semi annually or even annually. The time period is not that important. What is important is that on a regular bases you invest, regardless of what the market is doing; resisting the urge to invest more when the markets are good and not to invest or put off investing when markets are bad. Also, the longer the time frame the better. For example, investing every year of your working life (into an RRSP or just regular investing) is almost the optimum averaging plan. By analyzing a short period like 1997 we can see how this works.



The chart to the right shows monthly closing values for the DOW (top line) and the TSE (bottom line) from Dec. 31, 1996 to Dec. 23, 1997. From the chart we can see that it may have been best to do all our investing for the year either at the very beginning or in March. However, it is more likely that we would have invested a little during February, after two good months, then stopped when the market dropped in March, and then restarted investing over the next few months as the market improved. The human reaction would have been to invest heavily in July when the markets were hot. Then one might have started getting out or stopped investing after that when the markets dropped. However, if a person were to invest a regular amount every month they would have invested during the lower months, a little at the peak and would have continued to invest while the market was adjusting.

If it were not for human nature, then averaging might not be necessary. We understand that there

have been studies that show it is better to invest all at once early, than to average in. We do not know the details of these studies, but they do make sense. Over the long term, markets rise. This suggests that on average, the sooner you invest the better. The problem is that human nature will often cause us to wait for a better time. However, if we average in, we will not wait for the better time, and we eliminate the risk of investing everything during a market high. It has the added advantage of creating a habit of putting money away and investing it, rather than waiting until we have extra cash. Let's face it, how often do we have cash that we do not need or want for something else. Actually, when you think about it, averaging is probably the best way to set aside regular money, and it helps avoid buying high and selling low.

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