Rosefinch Research | Discussion on Averaging Investments

During social gathering, family and friends often share tips on mutual fund investments. The expert knows all about the products and shows great confidence on the next big fund. You are interested and make an investment and made good money! Excited, you top up and push all-in with your liquid cash. Unfortunately, the market turned quickly with paper profits becoming paper losses that's growing daily. You quickly cut and remark to the friends on social apps that "why am I always the lucky one…"

What you read above is unfortunately a too-common depiction of the new fund investors this year. They may have gone all-in at the peak, will the Averaging-Investment approach save the day? Let's return to the day after Chinese New Year and choose a different investment strategy:

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Return profiles of single investment vs averaging investment post-Chinese New Year

Source: Rosefinch. Lower or orange line is Single Investment; upper or blue line is weekly Averaging Investment.

As the result shows above, relative to the one-time single investment, the Averaging Investment gives higher return, lower drawdown, and a better experience. But Averaging Investment is not the Master Key to all problems. There are a few bugs in the practical usage of Averaging Investment.

Bug 1: Smile curve or cry curve?

People often hear about the Averaging Investors' Smile Curve. Indeed, when the market falls then rallies, Averaging Investment does best because it can accumulate cheap chips when market falls. But if the market is going straight up, then Averaging Investment is very inefficient. The Single Investment will be fully participating on the big rally. For the Averaging investment, the worst-case scenario is when the market rises first and then falls. In this case, investor is lacking exposure on the way up and adding exposure on the way down, so the return profile quickly turns from smile curve to the cry curve. Even if the underlying index or fund is flat at end of the cycle, the Averaging investor will have lost money.

Bug 2: marginalizing effect.

As the Averaging Investments accumulate, the periodic investment takes on smaller proportion relative to the outstanding investments, thus reducing its marginal impact. Victor Haghani, founder from Elm Partners' Funds, highlighted in his blog "What's the best way to get invested in the market" that the last few averaging investments make relatively little impact to the whole portfolio. According to Haghani, when we invest half of our total capital into the stock market, it's already giving us ¾ of the value; and when we invest ¾ of total capital, it's giving us 90% of the value.

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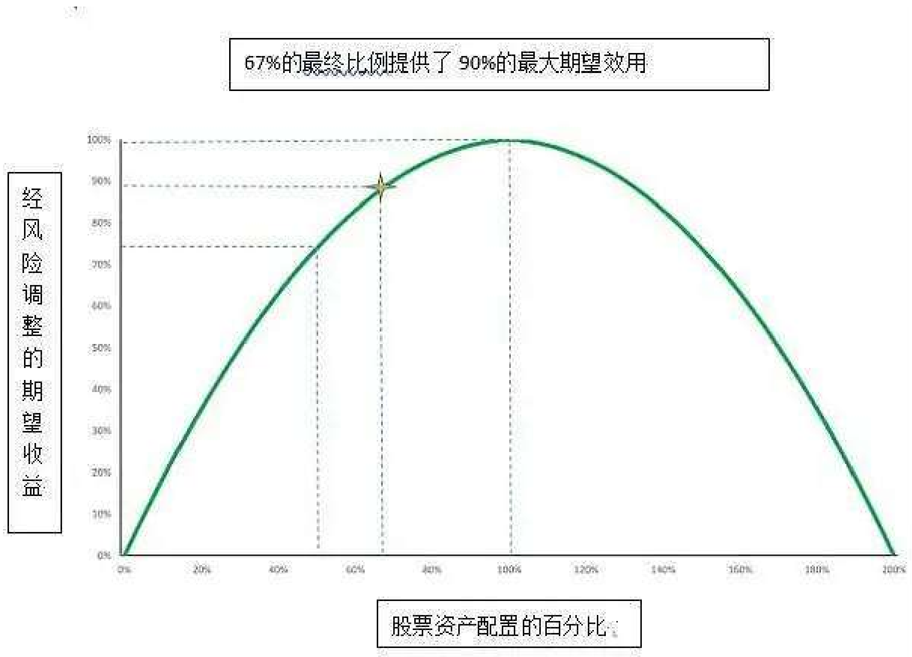

The X-axis is stock allocation percentage; Y-axis is risk-adjusted expected returns.

Bug 3: The return isn't necessarily high.

There's a popular slogan: "Averaging investment is the road to financial freedom" which may be an exaggeration. We did some analysis using Wind data on equity mutual fund index. In the period from 2010 to Oct 2021, we used tenors of 6m, 1y, 3y and 5y, and we compared how weekly Averaging investment did vs single investment. The result showed that from return perspective, single investment outperforms averaging investment across all tenors. For investors with high risk tolerance that prioritizes returns, averaging investment may not be the best choice.

Average return of Averaging investment and Single investment:

投资时间	6 个月	1 年	3 年	5 年
定投	3.3%	6.5%	22.7%	39.5%
单笔投资	6.3%	13.1%	37.7%	66.7%

Source: Rosefinch, Wind. Tenors on top row; Averaging Investment returns on 2nd row; Single Investment returns on 3rd row.

But we do believe Averaging investment reduces risk of high drawdowns and improves the winning ratio. For short tenors of 6m or 1y, there's not significant difference in probability of positive returns between the two strategies. But once we go to 3y, the averaging investment strategy has a 88% chance of getting positive returns, or over 10% higher than Single investment strategy. As the investment period

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increases to 5y, the Averaging Investment's winning percentage also goes up to 95%. More importantly, because the Averaging Investment has multiple investments over time, it decreases the risk of investor get in with max exposure on the top. Based on our results, we see that across all tenors, the risk of large drawdowns (over -10%) is lower for Averaging investment than Single Investment. So even though Averaging Investment doesn't increase our returns, it does decrease risk of large drawdown.

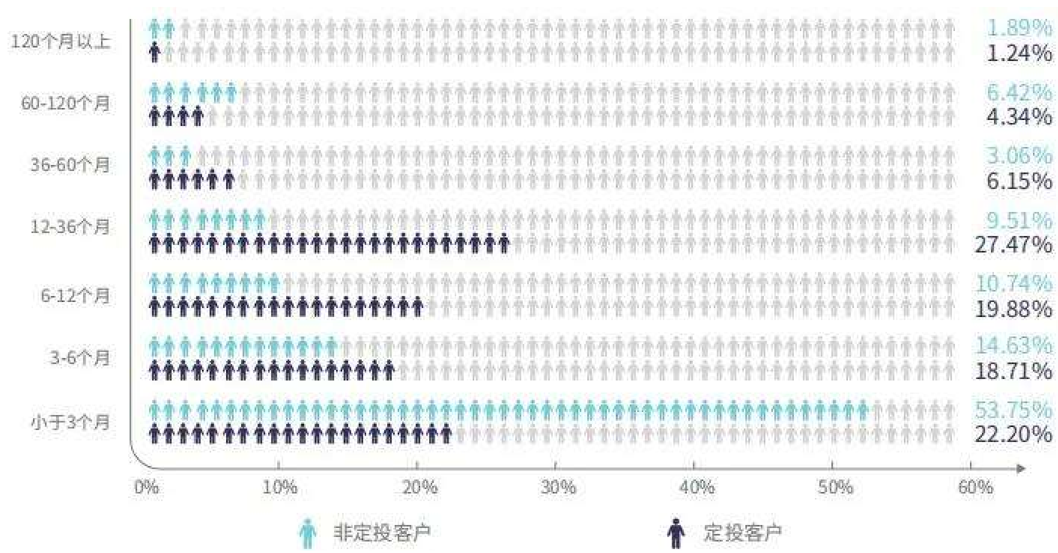
<u>Probability of losses over 10%</u>

投资时间	6 个月	1 年	3 年	5 年
定投	3.9%	8.0%	3.8%	0.0%
单笔投资	13.6%	16.7%	7.3%	0.0%

Source: Wind, Rosefinch. Top row is investment tenor; 2nd row is Averaging Investment; 3rd row is Single Investment.

Why are "reduce risk of large drawdown" and "increase winning percentage" important? Because only by investor having a pleasant experience can the investor extend the holding period. There's a recent investor analysis by several mutual fund companies that showed: amongst the non-averaging investors, only 20% hold onto their fund positions for over a year; while over 40% of averaging investors hold positions for more than one year.

<u>Comparison of holding period for Averaging Investors and non-Averaging investors</u>



Source: In-depth Report on Mutual Fund Investor Profitability. Y-axis is tenor in months. X-axis is % of investors.

As the holding period increases, both the winning percentage and return level increases. The report showed that about 60% of the Averaging investors have positive returns, or 10% higher than the non-Averaging investors. On average return, the Averaging investors also capture about 3% higher return.

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This shows that Averaging investors' psychological advantage increases their holding period, and the longer holding period is the key to increase profitability.

Overall Profitability Profiles of Averaging Investors and non-Averaging Investors

Source: In-depth Report on Mutual Fund Investor Profitability. Averaging Investors on left/light blue; non-averaging investors on right.

Therefore, Averaging investment and Single investment have their respective unique characteristics and advantages. We all know Warren Buffett as the heavy stock-picker who's always looking for the best at-bat opportunities. But for retail investors, he recommends averaging investment of US stock index funds. Victor Haghani believes the Single Investment is the best choice for most investors because it increases the efficiency of the deployed capital. The Averaging investment have lower expected returns and may provide some psychological advantage for investors. In Haghani's mind, the worst-case scenario is the huge opportunity cost of missing the rally due to waiting for the entry level. For example, in early 2009, if an US Investor wait for 10% retracement before committing 50% of capital, he'd be left without entering the market while the averaging investor would have captured over +300% returns. He therefore concludes that as long as you choose an investment method to overcome your inertia and stress and complete your capital allocation, then it's the right method.

As the legendary CIO of Legg Mason, Bill Miller said in his 3Q investor letter: time is the key for stock market wealth accumulation, not timing. Time is more important than timing, and you need to be "in it to win it." In the last 17 years, China's stock mutual fund's annualized return is about +15%, which is a cumulative +1167%. But if you miss the 20 days with the biggest returns, your return would drop by 2/3, with the cumulative return of +386%.

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Source: Wind, Rosefinch. Blue line is stock fund index; orange line is performance without top 20 days.

If you have strategy but lack tactic, you can learn the tactic. But if you only have tactic but no strategy, then you're stuck with the tactic. Whether it's the "perfect shot" or "accumulation over time", value investing focuses on building our capabilities, understand the true valuation, live with the volatility, and smell the rose of time.