DAS INVESTMENT

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Wealth accumulation via savings plan

Cost-Average-Effect: Smart Strategy or Expensive Myth?

The cost-average effect describes the advantage of buying more shares of securities when prices are falling and fewer when prices are rising. Manager Hans Peter Schupp is convinced that this can make an important contribution to reducing risk and increasing returns - despite criticism from the scientific community.

For many decades, fund savings plans have been a common practice for investors to build up their assets.

The argument with savings plans is: If you save a fixed amount each month in a fluctuating type of investment such as stocks, you automatically buy more shares when prices or rates are low. Over a certain period of time, the average share price in the investor's portfolio is thus lower than the average price in the market. This is a clever way for investors to take advantage of price fluctuations. The return and risk are thus in a reasonable relationship, because the cost-average effect is used.

Criticism on the cost-average effect

But is it really cheaper?

Well, the argumentation has been criticized time and again, most recently in a commentary in German financial magazine Wirtschaftswoche on June 18, 2023, entitled "This myth costs money."

As early as 1994, Paul Samuelson, winner of the Nobel Prize for Economics, called advertising with the average cost effect a "blunder, if not a crime". In German, "a gross error, if not a crime."

The methodological approach is called into question when returns are arithmetically averaged. Here is an example: a stock price falls by 50 percent and then rises by 100 percent to its initial value. The average return is +25 percent (-50 percent +100 percent / 2), although nothing was earned over the entire period. The correct approach here would be the geometric mean (1-50 percent) (1 +100 percent) -1 = 0.

Furthermore, it is argued that in the case of a savings plan, much less money is tied up on a time-weighted average than in the case of a one-time investment, and that returns are therefore not meaningful. While this is correct in terms of content, it says nothing about the cost-averaging effect.

It only shows that the savings plan - as the name suggests - is a form of asset accumulation, whereas the one-time investment is a reallocation within an existing asset.

Cost-average effect as an essential part of our investment process

For us, however, the cost-average effect is an essential part of our investment process, and not just for yield, but rather for risk considerations. Just as assets should be diversified across multiple securities, it also makes sense to spread the purchase of those securities across multiple points in time.

Admittedly, this approach is challenged in the academic literature, as it only works if prices in the investment period are also lower than at the time of the investment decision. In the other case, one only tries to catch up with running prices. However, this criticism applies mainly to momentum strategies, which are mostly implemented in growth companies.

However, with the Contrarian Value approach as we follow it, in which very early investments are made in companies and the position is then expanded when prices fall, it can be very successful.
An example: much too early and much criticized, we invested in Deutsche Bank shares after the Brexit decision in 2016 and consistently increased this position further until its low point. In the meantime, this has become a very successful investment. However, it took good nerves to do so.

Rebalancing is a key factor in our strategy

Even more important for us is the so-called rebalancing. This is also a way of cost-averaging. Price fluctuations on the stock markets cause the asset allocation of the portfolio to change due to differences in the performance of the individual assets, and these deviate to varying degrees from their target allocation. By selling some of the outperforming stocks and buying others with poorer performance, the desired risk level is maintained.

There are two strategies for doing this. The adjustment can be either time-based or bandwidth-based. Depending on how timely the portfolio is to be adjusted, these adjustments can be made either at a cut-off date or when certain tolerance levels have been exceeded. The latter method is used in the Contrarian Value Fund because we naturally monitor the performance of our portfolio on a daily basis and intervene immediately if the deviations from our target allocation become too large. Mostly, we use the inflows and outflows in the fund for this purpose.

Cost-average effect - a useful instrument for risk reduction

Even if there is justified criticism of the cost-averaging effect, we believe it is a perfectly sensible instrument for risk reduction in an existing portfolio and for asset accumulation.

Despite the positive performance of our Fidecum Contrarian Value Euroland fund since inception, it has proven advantageous for our investors to initially make a base investment due to the approach-related volatile performance and then increase the position in several steps over time depending on market assessment and risk appetite - in other words, to engage in cost averaging themselves.

About the author:
Hans-Peter Schupp has been working as a portfolio manager at Fidecum, a financial services provider he co-founded, since 2008. Previously, he was head of asset management at Mainfirst Bank.

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