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Season 2. Building personal wealth

Episode 9.

The benefits of regular investing

Hi there. Jason here. And in this Insight we'll start to explore ways to reduce the worry of investing your money in your ISA, your pension or any other investment plan, by looking at the two big benefits of investing your money regularly over time. Firstly, when you invest regularly compared to investing a lump sum, you're exposed to less risk of investing at a bad time. And secondly, there's a magical effect of regular investing which results in you buying your investments at less than their average price. And this fascinating effect, known by the experts as pound cost averaging, is something we'll come back to later in this Insight.

But before all that let's just recap on some key messages from earlier insights. We've talked about how the prices of even well diversified investment funds can fall, quite heavily, from time to time. We've explained why you should focus on your capacity for risk when choosing what risk to take with your money on each of your financial goals. And we've noted that investing regularly compared to investing a lump sum gives you more capacity for investment risk, because it reduces the risk of investing at a bad time. If you're not yet clear on these points have another look at the earlier Insights in this season.

Of course, just knowing that you have the capacity to take some investment risk on one of your financial goals doesn't necessarily make it easier to decide to invest. Nor does it mean you won't worry if markets take a big tumble, as they inevitably will from time to time, after you've started investing. So, let's look at an example to see how big falls in the markets if they're temporary, which they normally are, could be very good news for you when you're starting out on your regular investing journey.

Imagine for a moment that you've decided to invest some money on a regular basis to build a fund for one of your important financial life goals. Perhaps you want to help a child through college or take yourself on a trip around the world. Whatever your goal, let's assume that it's at least 10 years into the future and let's also assume that you plan to invest towards it by placing £3,000 into a stockmarket based fund now and another £3,000 next year. So, that's a total investment of £6,000. Now, to keep the numbers simple we'll assume that the price of your chosen investment fund is precisely £1 today. Which means that your first £3,000 investment will buy 3,000 units in the fund. That's £3,000 divided by £1 per unit.

Now let's further imagine that one year from now, when you're about to make your second investment of £3,000, the stockmarket crashes by 50 per cent, taking your fund price down from £1 per unit to just 50p. A situation which might make you question the wisdom of investing further at that point. But let's assume that despite your nervousness you carry on with your plan and make your second investment of £3,000. I'm assuming of course that nothing else had changed in your personal situation that might cause you to stop investing at that time.

Now the first thing you'd notice about your second investment is how it buys you a lot more units in your fund. In fact, this second £3,000 investment will buy twice as many units as your first investment, simply because the price of units has halved. Giving you 6,000 new units in your fund. That's your second payment of £3,000 divided by 50p. Which means you'll have bought 9,000 units in total - 3,000 from your first investment and 6,000 from the second. And to keep this simple we'll assume that you only make these two investments, and you're now keen to know what those 9,000 units could be worth in the future.

Of course, no one can predict how stock markets will move over time, but we can look back at the worst times in UK stockmarket history to see that markets normally recover relatively quickly after such a big fall. And if we use normal assumptions for investment returns and inflation we might assume that your fund price would grow from £1 to, say, £1.50 over your 10-year investment term. Which means that your investment would now be worth £13,500. That's your 9,000 units multiplied by the unit price of £1.50. And that's a quite incredible result when you think about it. Showing that it's possible to make a handsome profit on your investment of £6,000 spread over two years, despite starting to invest at the top of a market cycle, and just before a very bad market crash, and assuming only modest growth of around 3.5% each year plus inflation on your fund.

Of course, the reason for your good fortune in this example was precisely the crash in prices that might have worried you about investing in the first place.

In short, your second investment simply bought you a lot more units than your first.

Now, the important next question is whether regular investing in stockmarket based funds always produces super profits regardless of how the stockmarket performs? And sadly, the answer is no. As we can see if we swap the numbers around on our example to see what would happen if your fund price followed a very different path, whilst ending up at the same final price of £1.50. So, for example, if instead of falling in the first year your fund price had risen by 50% and then remained flat for the rest of your investment term your final plan value would have been £7,500. And here's why.

Your first £3,000 investment would have bought 3,000 units in your fund at the starting price of £1 per unit exactly as before. But this time, your second investment of £3,000 would only have bought 2000 units, because of the increased unit price of £1.50. So, in this scenario you'd have bought 5,000 units in total (3,000 plus 2,000), which would be worth £7,500 at the final fund price of £1.50 per unit. And that, whilst still giving you a profit, it's about 50% less than in our first example, despite the fund price ending up in exactly the same place.

Now, to be clear, we've assumed some extreme market movements in these examples and we've kept the numbers simple by assuming you'd just make two regular investments at the start of a 10-year term. In reality, markets very seldom move as wildly as our example. And, it's far more common, whether you're investing for your pension or another long-term goal, to invest monthly rather than annually. And to invest for many more than two years. And in those circumstances, you'd expect to see less variation in the outcomes as in these examples. However, it's essential to understand that your final return on any regular investment plan, regardless of your frequency of input, will depend on how your fund price travels up and down over time. So, your returns could be fantastic, if prices fell heavily or stay flat at the beginning of your savings period, before rising steeply in the later years. Or your returns might be disappointing, if your fund price shoots up initially before levelling off or falling later on. Which is why, despite the nice reduction in timing risk you enjoy with regular investing, you still need to review your plan every few years on your way to your longer-term goal. And ensure that your accumulated funds and separately your ongoing contributions are invested in funds that are suitable to your personal capacity for risk at that time.

One benefit you can be sure of with regular investing is 'pound cost averaging', which magically allows you to buy your investments at less than their average price. Now, whilst this might sound too good to be true, it’s really just the result of you buying more fund units at lower prices. And we can illustrate this using one of our earlier examples. So, in our first example the price of your fund started at £1 per unit and then fell to 50p one year later. So, the average price over that year was 75 pence. However, when we look at the £6,000 you invested divided by the 9000 units you bought, we get an average cost to you to buy your fund units of about 67 pence. A magical result – I think you’ll agree. So, the bottom line on regular investing is that big falls in markets are not something to worry about. Market setbacks, provided they take place in the early years of a long-term savings journey and recover over your investment term, can actually be very good news for the regular investor. You just need to remember to review your plan along the way to your longer-term goals, and ease back on your risk exposure as the date of your goal approaches.

There will, of course be times when you don’t want all of your invested monies exposed to the full force of stockmarket moves. And some people might also prefer to avoid higher risk investing at all times So, in the next Insight we’ll look at the types of fund that can be useful in these areas. See you back here when you’re ready for that. All the very best.

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