Unnerved by surging markets? Try value averaging - The Globe and Mail

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With the U.S. market continuing to hit new highs, many investors are wondering whether it's a case of too much too soon. During the past 10 months, the S&P 500 has risen nearly 24 per cent, including dividends. Vanguard's MSCI Canadian stock ETF hasn't kept pace, but it's up 14 per cent since June.

If fast market rises make you nervous, you might consider a "value averaging" investment strategy. It ensures that you invest more money when markets are in a funk and less when markets are rising.

The goal is to ensure you buy low and sell high. Occasionally, you'll be taking small pieces of profits off the table; other times, you'll be taking advantage of falling prices. Best of all, the application doesn't involve speculative judgment: just an iron-clad stomach (a mandatory requirement for falling markets) and a willingness to stick to the plan.

The method was first described by Michael Edleson, in his classic book, Value Averaging, last updated in 2006. The former Harvard professor found that the approach would have outperformed dollar cost averaging with the Dow Jones industrial stocks in 57 of the 66 years between 1926 and 1991, earning 13.77 per cent annually, compared to 12.61 per cent.

Results have been even better when markets are volatile. Value averaging with the Nasdaq index, for example, would have given investors a 15.2 per cent annualized return between 1991 and 2005, compared to 9.6 per cent through Dollar Cost Averaging.

Considering how manic-depressive global stocks have been during the past five years, I wanted to see how such a method would have performed with my Strategy Lab indexes.

I contacted Bruce Ramsey, of VA Investment software, asking him to run the data on a handful of exchange traded funds, similar to those that I'm using for Strategy Lab. Because Vanguard's ETFs weren't available on the TSX five years ago, I used their iShare equivalents, where necessary, for the back-tested analysis on the following products:

- XIC – iShares S&P TSX Composite Index
- VWO – Vanguard FTSE Emerging Markets ETF
- VTI – Vanguard Total Stock Market ETF
- VEA – Vanguard MSCI EAFE ETF
- XSB – iShares DEX Short Term Bond ETF

True to Michael Edleson's back-tested studies, value averaging would have performed spectacularly during the wildly gyrating markets we've experienced during the past five years. The emerging market index (VWO) would have earned 13.54 per cent annual returns from February 2008 to January 2013 compared to just 3.21 per cent with "dollar cost averaging." A lump sum invested over the five year period would have gained just 3.7 per cent a year.

Instead of investing equal dollar sums into the market each month (as with dollar cost averaging) value averaging investors mechanically sell some of the investment when profits rise above a predetermined growth rate, while buying more aggressively when the investment underperforms that return.

Such a strategy with the U.S. stock index (VTI) revealed strong results as well: 14.16 per cent for value averaging, 6.16 per cent for dollar cost averaging and just 5.16 per cent for a lump sum investment.

And with Vanguard's MSCI EAFE exchange traded fund, 9.25 per cent with value averaging, 2.37 per cent with dollar cost averaging and – 0.69 per cent for the lump sum.

The Canadian stock market (XIC) would have earned 3.25 per cent with value averaging compared to 2.35 per cent with dollar cost averaging and 1.34 per cent for the lump sum.

With the bond index (XSB) a lump sum would have been best, earning 3.78 per cent, versus 2.49 per cent with value averaging and 2.33 per cent with dollar cost averaging.

As with any method, of course, value averaging has its critics. Investors need to couple their investments with a money market fund–an available cash account that they transfer some stock market profits to when their investment growth exceeds a pre-determined goal. Conversely, they transfer assets from the money market fund to stocks when the stock market falls, so they can take advantage of falling prices.

The increased number of transactions would produce higher taxable consequences and commissions. To eliminate tax issues, you may want to try value averaging within a RRSP. Using TD's e-Series index funds would eliminate transaction commission costs.

Other critics have wondered where the cash for aggressive purchases is supposed to come from when markets keep falling. Such a drop could force a depletion of the money market cash reserves if investors are continuing to transfer assets from cash to stocks. In this case, Bruce Ramsey suggests if there's not enough capital in the money market account, then you either do nothing or invest whatever cash is available. And each month, you continue adding fresh savings to the money market account which – in the case of a falling market – you would transfer directly to the equities.

Those believing that we've entered a new era of increased volatility (and there are many) may warm to a value averaging approach. And if you're wondering what such practitioners are doing as the Dow hits new highs, well.... you probably know the answer. As the markets charge ahead, they're skimming off some of the cream.

It might not be a bad idea.