# The Value Averaging Investment Strategy

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Value Averaging (VA) is a hybrid of Dollar Cost Averaging (DCA), which is more familiar to most investors, and the process of portfolio rebalancing. Proponents of the VA investment strategy feel that this method allows those who use it to experience the proverbial "best of both worlds."

## How Value Averaging Works

Michael E. Edleson, a former Harvard finance professor, used simulations to compare the Value Averaging method to Dollar Cost Averaging (DCA) and also to the purchases of a constant number of shares in every investment period. While potential differences in risk were not considered, he concluded that Value Averaging provided investors with "an inherent rate of return advantage" in keeping with the time-honored recommendation to "buy low and sell high."

Edleson, who was also a former Nasdaq Chief Economist, feels that a missing ingredient has been added to DCA that makes Value Averaging a superior method - *focusing on a portfolio's anticipated rate of return*, which assists in pinpointing periods of under and over-performance in the stock market.

Dollar cost averaging is based on the principle that, rather than investing a large sum of money at one time, you should make small investments over a designated time period. For example, if you had $12,000 on January 1$^{st}$ that you planned to invest, you would invest $1,000 on a monthly basis through to December. It is felt that your risk would be reduced, especially in times of high volatility, because you would be purchasing stocks in a range of prices over a 12-month period, rather purchasing all of the shares in a lump sum for the same price.

With the Value Averaging strategy, whenever a portfolio under-performs, the share prices will probably also be low, and investors will therefore have to make a larger investment to make up for the under-performance. The converse is also true, and if the portfolio outperforms it's targeted rate of return, share prices will tend to be high as well, and that is not the time to purchase more shares. Investors may even profit from a sale, as long as they are guided by the portfolio target value, which is a calculated value. While dollar cost averaging has no rules for selling, value averaging forces sales when prices rise sharply and forces larger purchases - more shares purchased - when prices fall.

Value Averaging definitely proves its worth and works best when the stock market is highly volatile, because it forces investors to be disciplined when they invest.

### Using Value Averaging

VA is a formula based investment technique, where a mathematical formula is used to guide how much is invested into a stock at a specific time. VA's goal is to increase a stock's value, rather than its market price, by a calculated amount on a periodic basis.

To begin, you determine the amount of money you will need to set aside to reach a particular goal, such as financing your retirement. Next, based on the yearly return you expect to realize on what you invest, you calculate what you will have to invest every month in order to attain that goal. For example, if you plan on accumulating $500,000 within a 20-year period and determine that you can earn 8% annually, you would need to set aside approximately $875 each month. This would enable you to track your progress toward that goal on a month-by-month basis.

Note that with this method, the emphasis is on establishing a portfolio target value or "value path". For example, suppose that at the end of the 12th month you realize that your portfolio value should be at $10,950 according to your plan, but because of a downturn in the stock market, it is only worth $10,000. This indicates that in the following month, you should invest an additional $950 along with your usual $875 for a total of $1,825 in order to stay on track.

Realistically, this is a procedure that you would follow every month, and whenever you fall behind, you would add to your monthly investment. By way of contrast, whenever the return on your investment was higher than you expected and your portfolio was worth more than the pre-determined value, that would be the time to reduce your usual investment or consider selling some of your stock.

Value averaging can also be modified so that no sales take place, which is important when investing in non tax-sheltered accounts.

### What You Can Expect

Value averaging has been proven to work better than DCA in almost all market conditions, the benefits of which are really accentuated in a highly volatile market.

Under the Value Averaging approach, the ending portfolio value will be pre-determined before you start your investing program, so as in our example above the ending value is $500,000. In other words, when you start the value averaging program, the ending amount is known, but the amount to be invested monthly varies.

Under the Dollar Cost Averaging approach, the total portfolio value at the end of the period could be any value, but the total amount to be invested is fixed - in this example, 12 months times 20 years times $875, for a total amount invested of $210,000. When you start a dollar cost averaging program, the amount to be invested is known, but the ending amount isn't.

In summary, Value Averaging is an investment strategy that provides a high probability for investors to reach their investment goals and it is a promising investment technique that merits broader attention from financial advisors, financial institutions and the investing public.

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*For a more theoretical review of the two strategies and examples of how they compare under different market conditions, visit* *www.valueaveraging.ca*