

## A market entry strategy for your clients

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***Your client insisted on taking his or her portfolio to cash some time ago. You want to get them back in the market but they're scared away. What can you do?***

While your client may be convinced that holding cash is the easy thing to do, we believe that the client will likely regret this decision down the road. Depending on if and when they get back in the market, they could miss all or part of a growing market and the opportunities this offers.

Your challenge with this client-type is to get them back into the investment markets. However, they'll probably be squeamish about any approach that has them jumping right back into equities. Here's a strategy to try with your clients who fit this scenario:

### **The strategy**

Start your client out in a fully-diversified, defensive (bond based) portfolio, then, agree on "pound cost averaging" (PCA) to get them back into equities by moving a certain percentage of their portfolio into equities at regular monthly intervals, for example over a 6, 9 or 12 month period. This way, more shares are purchased when prices are low and fewer shares are bought when prices are high. The example we are using here is assuming a move over 6 months.

### **The rationale**

#### **THE DEFENSIVE PORTFOLIO**

You probably don't want to buy only low risk assets that worked well recently – Government Bonds and cash. We believe that a more reasonable assumption of risk versus reward is to buy a fully diversified defensive portfolio. However it is worth noting that our models indicate the expected returns from equities in the relative near term are higher than those we expect from bonds; the issue is that we expect equity volatility to remain at the elevated levels we have experienced over the last several months. Of course, bonds can also lose money and the underlying assets may default; they are by no means "risk-free," but historically they have carried less risk than equities.

#### **POUND COST AVERAGING (PCA)**

Pound cost averaging is designed to lessen the risk of investing a large amount in a single investment at the wrong time. The genius of PCA is that it makes it easy to get over the psychological barriers of investing in down markets, when stocks are cheap. For your clients, dipping their toe gently into the stock market using a PCA-like strategy might be the only way they are willing to buy stocks at all. We believe clients are better off using PCA than doing nothing.

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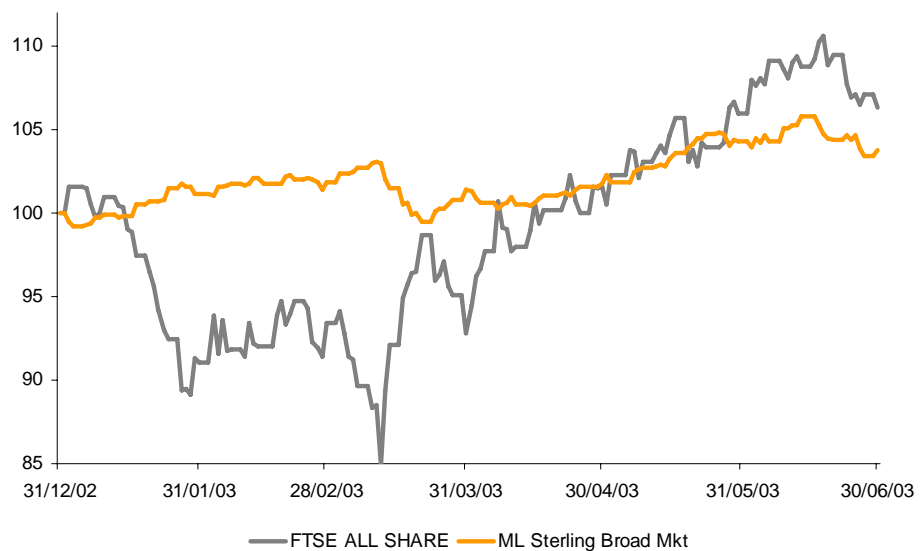
### How to do it

Once you have your clients in a defensive portfolio, you can begin the process of pound cost averaging them back into a diversified portfolio with equity exposure over a 6-month time period. As a review, PCA is a technique designed to reduce market risk through the systematic purchase of securities at predetermined intervals and set amounts. Instead of investing assets in a lump sum, the investor works his or her way into a position by slowly buying smaller amounts over a longer period of time.

In order to begin a PCA plan, you must do three things:

1. Decide exactly how much money you can consistently move to equities each month. Make certain that the portfolio can sustain the same amount every month or the plan will not be as effective.
2. Select the investments that you want the client to hold for the long term, preferably five to ten years or longer.
3. At monthly intervals, invest that money into the security or securities you've chosen for the client.

Here's a simple example from around the time of the last major market bounce – a couple of years after the bursting of the tech bubble, when things started to recover.



Let's assume your client had moved to cash at the start of the downturn in 2000 and was only willing to start moving to a diversified portfolio after a couple of years, in Dec 2002. You could have suggested they invest in a defensive portfolio (represented here by the orange line, Merrill Lynch Sterling Broad Market Index), then pound-cost averaged out of this into an equity portfolio (represented here by the grey line, the FTSE All Share Index). Your client would have benefited from the relative solidity of the defensive assets when the equity market was very volatile whilst increasing their equity allocation slowly whilst equities were still cheap.

In this example, we assume the appropriate ending portfolio is a 40/60 bond/equity portfolio.

Total amount to invest: £100,000  
 Monthly amount to move over 6 months: £10,000

	Bond Allocation	ML SBM Bond Index	Equity Allocation	FTSE AS Equity Index	Total Market Value
<b>Dec 02</b>	100,000	168	0	1924	£100,000
<b>Jan-03</b>	90,000	170	10,000	1751	£100,138
<b>Feb-03</b>	80,000	171	20,000	1797	£101,230
<b>Mar-03</b>	70,000	171	30,000	1786	£100,729
<b>Apr-03</b>	60,000	171	40,000	1954	£104,681
<b>May-03</b>	50,000	175	50,000	2039	£108,106
<b>Jun-03</b>	40,000	175	60,000	2046	£108,116

This hypothetical example is for illustration only and is not intended to reflect the return of any actually invested pounds, Equity Index is FTSE All Share, Bond Index is Merrill Lynch Sterling Broad Market. Cash proxy used is FTSE 7day Loc Auth cash.

Note that the ending asset allocation is: 60% equity and 40% fixed income. The return for this pound cost average approach over the 6 months was 8.1%. Had the client remained in cash during those 6 months, the return would have been just under 2%.

The client benefited because importantly they had re-entered the market in a way that made them feel comfortable and were buying equities whilst they were low (represented by the index level column in the table) giving them a better chance of maximising their returns when the market turned.

### Time NOT timing

Obviously these clients will miss out on the start of equity growth on their entire portfolio because of their bond holdings, but they could face a much bigger opportunity loss if they continue to sit on the sidelines in cash. We can't emphasise strongly enough—*relying on timing is a very risky strategy, with very few examples of success.*

Remind your client that they need to maintain an appropriately balanced portfolio to ease shock when asset classes or sectors take a tumble and they need to stay invested in equities if appropriate to their goals and time horizon. Historically, equities have outperformed bonds and beat inflation. Investors must keep in mind all that happened before and after they began investing. This is the key to designing portfolios for the next 5, 10 or 20 years.

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