PORTFOLIO

Easy Way to Buy Low

Selling high is a tricky proposition, but this simple trick can help you nail the other half of the investing equation. **By Craig L. Israelsen**

The basic rule for investment success is as old as the hills: Buy low, sell high. But actually doing it can be surprisingly difficult.

Selling a stock or fund that has been performing well is tough. The temptation to ride the rocket just a little longer is very strong. So let's focus on the other element: Buy low.

I propose a disciplined investment approach that measures performance against an annual account value target. If the goal is not met, the account is supplemented with additional investment dollars to bring it up to the goal. (For this exercise, I capped supplemental investment at $5,000, in acknowledgement that investors don't have endlessly deep pockets.)

Very simply, the clients will "buy low" in years when the account value is below the target. If, however, the target goal is met at year's end, the clients get to do a fist pump and treat themselves to a fancy dinner or other reward.

One benefit of this suggested strategy is that it is based on a specific performance benchmark rather than on an arbitrary market index (such as the S&P 500) that may not reflect the attributes of the portfolio being used by the investor.

COMPARING STRATEGIES

For an example of how this works, see the "Comparing 3 Portfolios" chart on page 72. It shows the end-of-year account values over a 15-year period (1999 through 2013) of three different portfolios, based on a $5,000 annual investment.

The first portfolio is a theoretical one, in which the target level of performance is a constant 8% annually; the shaded area shows the end-of-year account value. A second portfolio, represented by a solid blue line, is an actual multi-asset portfolio that averaged 8.44% over the 15 years; that line marks the end-of-year account value.

Both those portfolios ended up with particularly similar account values: $146,621 assuming a constant annual return of 8%, and $148,069 using actual year-to-year returns.

The difference between the two portfolios was the fluctuation of the "actual" portfolio's account value along the way. The steady 8% per year portfolio experienced steady upward growth with no declines – no surprise there.

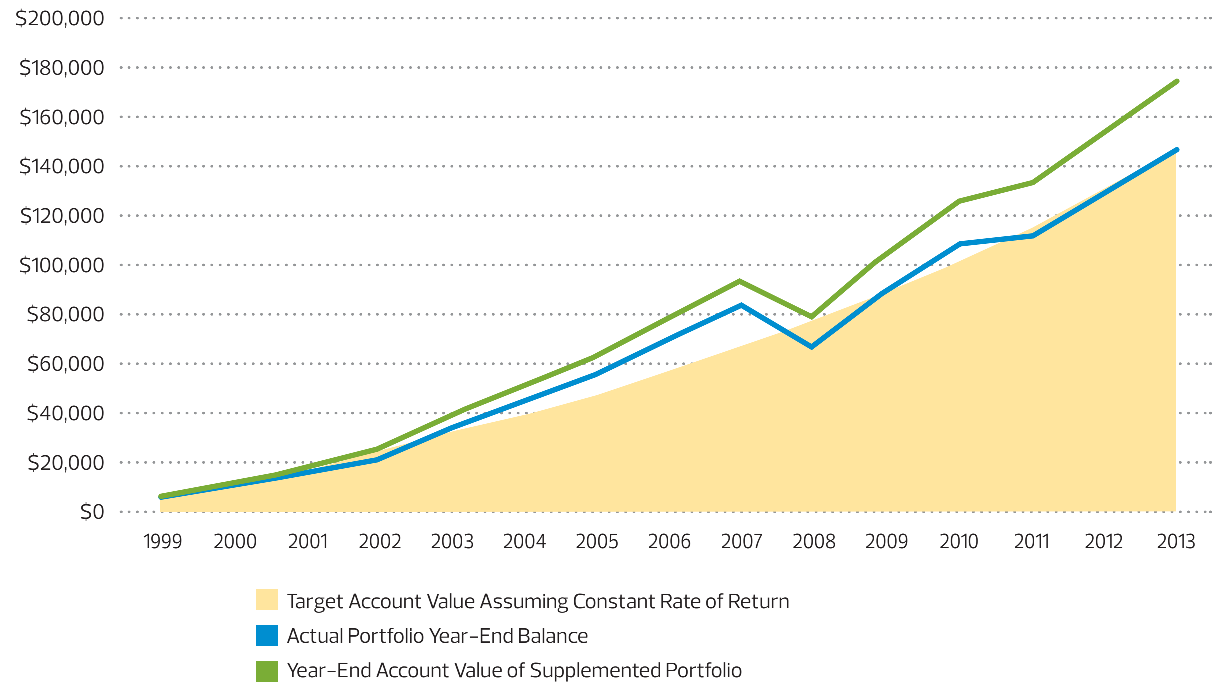
The end-of-year account value of the actual multi-asset portfolio (using 12 asset classes in equally weighted allocations), on the other hand, fell below the target portfolio in 2001 and 2002, then bolted ahead from 2003 to 2007. In 2008, 2009, 2011 and 2012, it again fell below the target account value.

For this exercise, we have now reached the key moment: What should clients do in the years that their portfolios fall below the level of the target account value? The answer is buy low.

When the portfolio is above the value of the goal, meanwhile, investors should simply do nothing.

COMPARING 3 PORTFOLIOS

The area in yellow tracks the annual year-end account value of a target 8% portfolio. The blue line shows an actual multi-asset portfolio with 8.44% annualized growth, and the green line shows the impact of a buy-low strategy.



Source: Lipper, author calculations

And in either case, the multi-asset portfolio should be rebalanced at the end of each year (which was done in this analysis).

SUPPLEMENTAL INVESTMENTS

There's a third portfolio shown on the chart: the green line that runs along the top, showing the outcome when the clients supplemented the portfolio with the buy-low strategy.

During the 15-year period shown, there were six years in which the actual portfolio account value fell below the goal portfolio (again, that's 2001, 2002, 2008, 2009, 2011 and 2012). To bring the account value up to the level of the goal portfolio in those four years, the buy-low investor had to make the following investments at year's end: $1,273 in 2001, $3,242 in 2002, $5,000 in 2008 (the actual difference would have been $11,312), $60 in 2009, $3,640 in 2011 and $587 in 2012.

You can see the profound results in the "Buy-Low Payoff" chart on the following page: The ending account balance of the buy-low approach was $174,372.

Admittedly, the supplemented portfolio had a cost – namely, the six additional annual investments totaling $13,802, made during the down years. But even after accounting for that, the supplemented portfolio was still $12,501 better off than the portfolio without a buy-low strategy.

It's worth noting that the added value produced by this buy-low strategy did not rely on clever market timing in advance of a big run-up in

BUY-LOW PAYOFF

Add up the value of supplemental contributions made during a portfolio's down years.

Actual portfolio balance without buy-low strategy:	$148,069
Six additional buy-low investments:	$ 13,802
Total portfolio balance + cost of additional buy-low investments:	**$161,871**
Ending portfolio balance with buy-low strategy:	**$174,372**
Added value of buy-low strategy:	**$ 12,501**

the performance of the portfolio. It simply engages a dollar cost averaging protocol – but only on the downside, which is where the real value of dollar cost averaging resides.

HOW TO EXECUTE

The challenge of this approach is that it is hard for investors to actually pull off. When a portfolio's value has declined, adding more money to the portfolio runs contrary to an investor's typical panic response.

Clients should buy low whenever their portfolios fall below the target account value.

This is where an advisor's outside advice is critical, of course – but even so, planners must discuss this type of approach with clients long before the moment of action.

Financial planners may want to consider the following approach to getting clients to choose this strategy:

First, encourage clients to set an annual account value target for portfolio performance – such as 6% or 8% – rather than comparing the performance of their portfolio to a single index like the S&P 500, which is not a multi-asset index.

Then, whenever the actual performance of the portfolio lags behind the target level of performance, encourage clients to supplement the portfolio to bring it up to the target value.

If they cannot or will not provide a full supplement in down years, encourage them to add whatever amount they are willing to commit. And remind them that buying low is what this is all about. FP

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