Stock Market Review

The cost averaging strategy

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The strategy of 'averaging down' involves investing additional sums of money into a financial instrument if the price declines significantly from the initial entry point.

The rationale is to bring down the average acquisition cost per share closer towards the market price at the time of the decline so that once the price eventually moves up an investor can lock in a profit quicker.

However, before taking such a decision an investor needs to analyse the reason for the decline in the price. Is the drop in the share price one of a temporary nature or is the company in question facing serious financial difficulties and it will be very hard for the equity to recover from the low levels? Investors therefore need to have enough knowledge of the company to formulate a view on the reason for the share price decline.

Accumulating more shares at a lower price in a company that has a strong balance sheet and a positive outlook is more beneficial for investors who intend to keep shares for the longer-term. This is why such a cost averaging technique is normally looked at favourably by many value investors as opposed to short-term traders who are interested in quick share price movements irrespective of long-term fundamentals.

Value investors such as the legendary Warren Buffett who understand the business are usually not concerned at a decline in a share price. On the contrary, value investors are generally pleased when prices decline since it would provide them with an opportunity to buy more shares.

For investors to be in a position to average down, they need to hold sufficient liquidity to be able to take advantage of such market opportunities. It is therefore important for investors to maintain adequate levels of liquidity or to hold a portion of one's portfolio in securities (such as fixed income or money market) that can easily be liquidated to maintain flexibility and average down an investment immediately as the opportunity arises.

However, averaging down also entails risks and by investing more money in the same company, an investor is more vulnerable to the fortunes of that company since the percentage allocation to that security is higher. At times, this could lead to further losses so an investor must be well-informed before executing such a strategy.

Some investors who prefer not to commit more capital to a particular investment either simply hold on to the original investment hoping that this may eventually recover although it could take a considerable number of years to do so. On the other hand, other investors may indeed decide to sell the original shares and recognise the loss. Such investors would then seek to recover such a loss by investing in other companies which may be offering a possibly more rewarding risk-return trade-off. Equity markets are volatile by their nature and therefore present opportunities for investors to take advantage of price anomalies caused by changes in investor sentiment mainly reflecting overall market and economic conditions. The cost averaging technique may be particularly useful when general sentiment is fearful since panic selling normally results in high-quality blue-chip companies becoming available at compelling valuations.

That was precisely the scenario in late 2008 and early 2009 when most local and international share prices declined significantly irrespective of company fundamentals. That was clearly a time for such a cost averaging technique to be considered. However, while the market at the time presented some fantastic opportunities for investors as evidenced by the fact that these share prices have now recovered strongly since then, other companies have not recovered to the same extent possibly due to their weaker fundamentals and the impact of the financial crisis on their balance sheets.

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Some of the multinational companies such as Procter & Gamble, Apple, PepsiCo and Johnson & Johnson whose share prices had declined to unreasonable levels in 2008/9 only to recover within a couple of years provide a clear example of the state of the market then and the opportunities presented to investors.

Such opportunities were also widely available in the local market. Few investors may remember that at the time of the very weak investor sentiment following the start of the international financial crisis in 2008 and 2009, the share prices of Bank of Valletta plc and HSBC Bank Malta plc had declined to as low as €1.068 and €2.08 respectively. Since then, these equities have climbed by 112 per cent and 32 per cent providing investors with an opportunity not only to average down if one had previously purchased shares at a high level but also to benefit from the consistent dividend distributed semi-annually to all shareholders.

Likewise, the share price of Malta International Airport plc had slumped to as low as €1.00 but has since almost doubled to the €1.80 level on record financial results and also improved dividends. MIA's downturn in passenger traffic in 2009 was clearly of a short-term nature in reaction to the weaker international economic conditions and the resulting low share price at the time offered investors an outstanding opportunity to acquire shares in this company at very attractive levels.

More recently, the three IT companies listed on the Malta Stock Exchange had dropped to record low levels and have since rallied strongly. In hindsight, the decline in the share price and the subsequent availability of shares for a period of time at very low price levels was a rare opportunity for shareholders to average down from the much higher levels at the Initial Public Offering stage that all 3 companies conducted in 2007 and 2008. Crimsonwing plc had dropped to as low as €0.16 between February and April 2012 from an IPO level of €0.50.

This equity has since rallied by no less than 237 per cent to €0.54 on evidence of a much improved financial performance, confirmation of new lucrative international contracts and the company's bullish expectations of achieving a level of €2 million profits by the next financial year to 31 March 2014. Similarly, RS2 Software plc had briefly dropped to a low of €0.30 in March 2011 but after a brief rally it had stablised around the €0.50 level for a substantial period of time between May 2011 and September 2012 providing investors with ample time to consider such a cost averaging opportunity. The price has climbed by over 70 per cent since last summer following announcements of the new contracts won by the company.

6pm Holdings plc was the more recent example of the benefits of undergoing a cost averaging exercise as the equity last week rallied by over 44 per cent on the announcement of new contracts won in the UK.

On the other hand, companies such as Middlesea Insurance plc and Go plc suffered sharp downturns in their share prices from significantly higher levels in the past reflecting the actual losses incurred by both companies from their respective ill-fated international business activities in Italy and Greece respectively. While it may be debatable whether the share prices of both companies ought to have suffered less of a decline following the losses incurred, shareholders of these companies should not have based any cost averaging decision on the assumption that such equities will regain the record levels of past years.

Investors need to gain access to information to know when would be the right time to consider such cost averaging in a particular company. Investment advisers who conduct regular research can provide a client with the necessary insight as to whether a company has a positive outlook and business pipeline including a strong balance sheet, or whether the company may still be undergoing a difficult and unprofitable period and a further purchase of shares in the company would be a classic example of 'throwing good money after bad'.

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