Capital Group Private Client Services

Should you add more to your stock holdings now or later?

Although equities have delivered the best long-term track record of any major asset class, the past few years have created some anxious and frustrating moments for investors. During the credit crisis that began in October 2007, the MSCI World Index dropped as much as 57% from its peak. Then, from the trough in March 2009 through the end of 2010, it skyrocketed more than 90% as the economy improved and corporate profits made an impressive comeback.

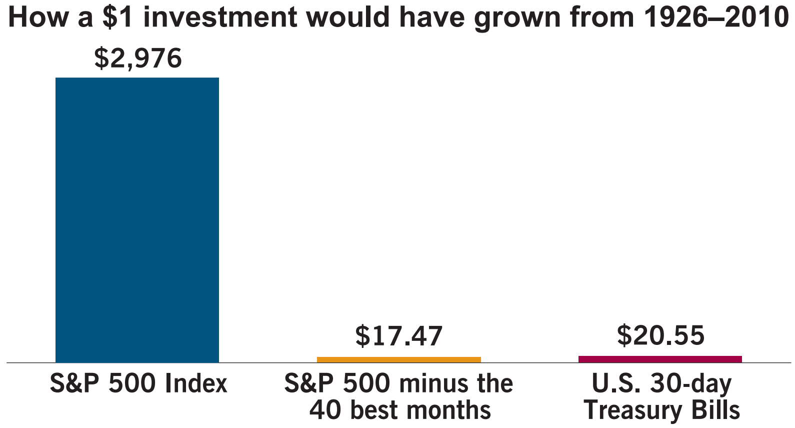
Sadly, many investors missed out on the tremendous market rebound. The pain of recent losses, coupled with fears that the worst wasn't over, caused them to move to the sidelines, resulting in unprecedented transfers into cash and bonds, which they perceived as being safer than the stock market.

Numerous academic studies show that our natural human instinct to avoid pain frequently causes us to choose the path we believe offers the least likely exposure to harm—often to our detriment. Our desire to minimize loss plays a significant role in decision-making when it comes to investing and can impair our ability to accumulate wealth. For instance, even though the average investor has a long time horizon and a need for growth, the tendency is to avoid stocks if it appears that a period of market weakness lies

The decision regarding whether and how to increase your exposure to equities comes down to your personal goals and risk tolerance.

Market timing can be a very costly endeavor

How a $1 investment would have grown from 1926–2010



Source: Capital Group Private Client Services

Figure 1

Please see important footnotes on page 5 for additional information on this chart.

ahead. Unfortunately, one's perception of the future is heavily influenced by recent experience, which may lead to "rearview investing." This can result in jumping out of the market after a damaging loss (selling low) and hesitating to reenter until confidence returns (buying high).

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Now that stocks have doubled from their recent lows, many are asking if this is a good time to get back into the equity market. Though no one can accurately or reliably predict the future, in this paper we will explore some important considerations in response to that question.

THE DIFFICULTY OF MARKET TIMING

History and research tell us that it's impossible to time market movements with any degree of accuracy. That is why we strongly believe in building an appropriate long-term asset allocation based on an investor's time horizon, risk tolerance, risk capacity and financial objectives. Retreating from the market at just the wrong time, or being out during spurts of strength, can be costly, suggesting that investors are often best served by staying the course through short-term fluctuations. As shown in Figure 1 on the previous page, a dollar invested in the stock market in 1926 would have grown to $2,976 by the end of 2010, despite all the damaging bear markets along the way. Missing just the best 4% of months during that period would have lowered your ending value to $17.47, less than the $20.55 you would have earned by investing in U.S. Treasury bills.

Some investors believe certain economic signals correspond to market declines. To test this thesis, we looked at a broad range of economic environments in the postwar period, beginning in 1946. Over that time span, we found that stocks made money in 78% of the rolling 12-month periods, including both weak and strong environments. We then looked at more challenging times, such as when inflation was high, gold prices were surging or unemployment was elevated. Surprisingly, we found that the equity markets overwhelmingly delivered positive returns even during these tumultuous periods. As Figure 2 below illustrates, only recessions seemed to have a reliably dampening effect on stocks, but to avoid those periods, investors would have needed to know that economic downturns were on the horizon before they hit.

Stocks tend to rise in most environments

Over 12-month periods when...	Frequency of gains	Frequency of losses
Inflation was greater than 5%	64%	36%
There was deflation	74%	26%
Gold prices rose more than 20% (since 1977)	87%	13%
Unemployment was above 7% (since 1948)	82%	18%
Fed funds rate rose 1% or more (since 1954)	82%	18%
We were in a recession (since 1947)	52%	48%
All 12-month periods (1946–2010)	**78%**	**22%**

Source: Capital Group Private Client Services **Figure 2**
Please see important footnotes on page 5 for additional information on this table. Equity results are represented by the S&P 500 Index from 1946–1969 and a blend of 70% S&P 500 Index/30% MSCI EAFE Index from 1970–2010.

We also looked at whether there have been reliable patterns of strong markets following on the heels of weaker periods. Figure 3 highlights the frequency of various ranges of market returns over the same postwar period. While double-digit losses occurred in 11% of the 12-month periods, gains of more than 20% occurred far more frequently—nearly one-third of the time. After a year of double-digit declines, the market rebounded admirably almost half of the time, delivering a return of 20% or better. However, a second year of double-digit declines struck in about 25% of the cases. With that kind of bifurcated outcome, it's no surprise that investors can't rely on recent market behavior to reliably predict future results.

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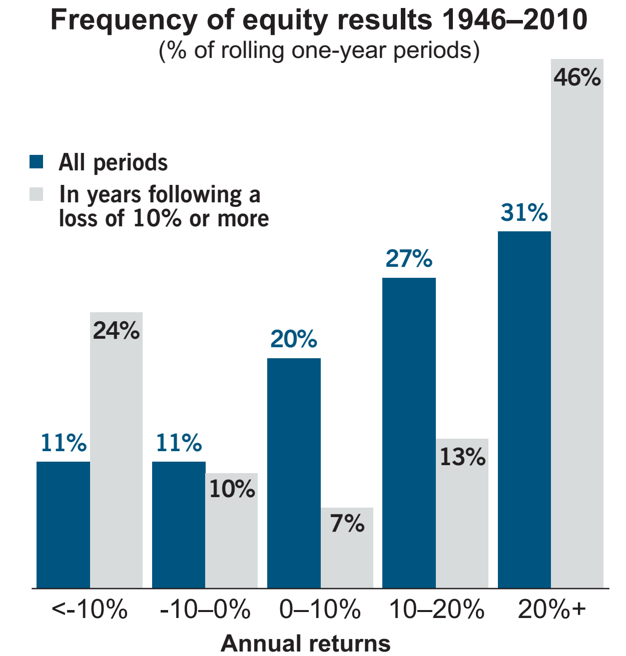
The stock market has been up nearly 80% of the time over the past 65 years



Source: Capital Group Private Client Services **Figure 3**
Equity results are represented by the S&P 500 Index from 1946–1969 and a blend of 70% S&P 500 Index/30% MSCI EAFE Index from 1970–2010.

OPTIONS FOR ADDING TO STOCKS

If your current allocation to equities is lower than your target, you may be considering the possibility of increasing your exposure to stocks. But should you boost your allocation to equities all at once, or is it better to systematically reinvest through dollar cost averaging (DCA)? And if DCA is the right choice, over what time period should this technique be employed? As with any investment decision, both the choice to engage in a scaled reentry and the selection of a timeframe over which the process is accomplished must be carefully weighed.

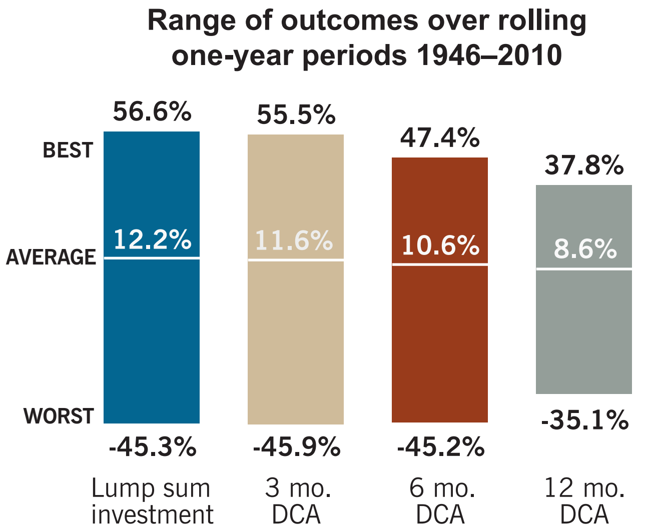
Dollar cost averaging refers to making systematic investments into the market over a given period, normally ranging from three months to one year.

Because equities rise far more often than they fall, the odds are stacked in favor of immediate investment. However, if avoiding short-term pain and disappointment is a primary objective, DCA may be a prudent compromise to putting it all in at once.

HOW BEST TO "AVERAGE IN"

We examined 65 years of equity index data to estimate the range of outcomes one would have experienced in the first year after initiating a stock market investment under several different scenarios: investing a lump sum of cash immediately or spreading it out evenly over three, six and 12 months. As you can see from Figure 4 on the following page, the potential rewards were much greater when the funds were invested more quickly, but so was the risk. During the very best 12-month period for the market, a lump-sum

While averaging in lowers risk, it can also reduce your returns in rising markets



Source: Capital Group Private Client Services **Figure 4**
Equity results are represented by the S&P 500 Index from 1946–1969 and a blend of 70% S&P 500 Index/30% MSCI EAFE Index from 1970–2010. Cash represented by the IA SBBI U.S. 30 Day Treasury Bill Index.

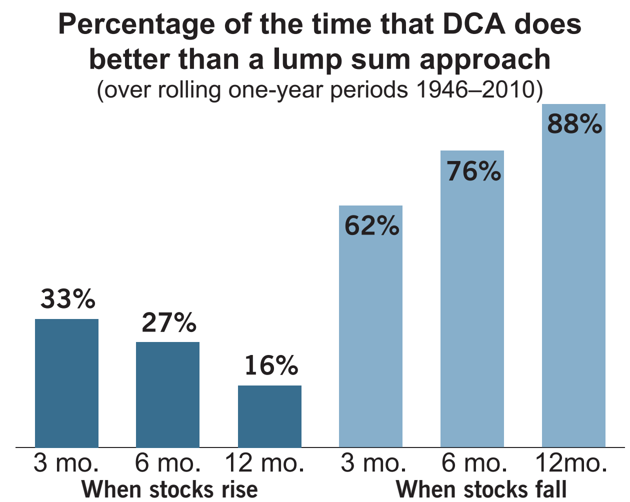
investor's return would have been 56.6%. However, a lump-sum investor would have experienced a loss of 45.3% had the investment been initiated at the beginning of the most challenging 12-month period evaluated. Three- and six-month DCA would have reduced the potential upside, but would have provided essentially no downside improvement over immediate investment in the most damaging markets. Only when DCA spanned the full 12 months would there have been any noticeable downside improvement, with the lowest return coming in at –35.1%, a 10 percentage point improvement over investing a lump sum. This relative safety comes at a price, however, because the 12-month DCA investor would have achieved a lower return than the lump-sum investor in both average and robust markets.

To break this down further, Figure 5 shows the frequency of success for various dollar cost averaging alternatives relative to immediate investing. You'll note that DCA rarely does better than lump sum investing in rising markets, with the slower approach (12-months) being more advantageous only 16% of the time. This is not surprising given the simple fact that cash kept on the sidelines reduces results in average or stronger markets. Conversely, that same slower (i.e., 12-month) approach has proven superior 88% of the time when markets were weak.

Because most investors have time horizons longer than one year, we extended our analysis of the results achieved in the very best and worst stock markets and found that the final outcome is far more impacted by what happens over the next four years than by what occurred in just the initial 12 months.

This is a great reminder that the most important decision regarding whether and how to increase your exposure to stocks comes down to your long-term wealth accumulation goals, risk tolerance and risk capacity. If short-term fluctuations create undue anxiety, a 12-month DCA approach might reduce your discomfort. But if you are willing to take a longer-term view, putting cash to work faster improves the probability of better overall results.

Dollar cost averaging works best in weaker markets



Source: Capital Group Private Client Services **Figure 5**
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A BALANCED APPROACH

Our discussion thus far has focused exclusively on stocks, ignoring the fact that a typical core portfolio includes a mix of stocks and high-quality bonds. A balanced approach combines assets that don't move in lockstep, with bonds often providing a nice offset to equity market dislocations. A traditional allocation of 60% stocks and 40% bonds would have helped to deliver protection during tough periods for stocks. So while the question remains whether now is the right time to reenter the equity market, keep in mind that a balanced portfolio can assist in providing meaningful downside protection, with or without the need to utilize DCA.

CONCLUDING THOUGHTS

Though short-term market volatility can be disheartening, the rewards of equity investing over time have been compelling. An investor's primary goal should be to establish a prudent long-term investment policy that can be sustained during the most challenging markets. While many investors implement their intended allocation immediately upon establishing the appropriate strategic mix, for those with a lower emotional tolerance for short-term volatility or a heightened perception of risk in the market, a dollar cost averaging approach may be the best solution for achieving one's targeted equity allocation. ■

Key points

- As a result of market declines and economic uncertainty over the last few years, many investors have been sitting on the sidelines in cash and bonds.
- For those wanting to increase their allocation to stocks, historically the best average results have been achieved by making a lump sum investment, since over time the market tends to have an upward bias.
- A dollar cost averaging approach may be prudent for those investors who are still on the sidelines and have a heightened perception of risk.
- A faster plan for getting fully invested has worked best in rising markets, but scaling in over 12 months has historically provided noticeable protection in the worst of times.

Figure 1: Hypothetical value of $1 invested on December 31, 1925. Results reflect the reinvestment of dividends, interest and other earnings and exclude fees and taxes. Calculated by Capital Group Private Client Services using data from Morningstar software products, ©2011 Morningstar Inc. All rights reserved. Used with permission. Past results are no guarantee of future results.

Figure 2: Inflation – Source: IA SBBI U.S. Inflation Index; Time period: 1946–2010; Deflation – Source: IA SBBI U.S. Inflation Index; Time period: 1946–2010; Gold – Source: S&P GSCI Gold Spot; Time period: 1977–2010; Unemployment – Source: Bureau of Labor Statistics; Time period: 1948–2010; Federal Funds Rate – Source: The Federal Reserve; Time period: 1954–2010; Recessions – Source: Bureau of Economic Analysis; year-over-year decline by quarter; Time period: 1947–2010. Past results are no guarantee of future results.

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