

Want your mutual fund investment to make more money?

By: V Parekh

Buy low, sell high -- that's what every investor in the world wants to do.

Many investors have been told that systematic investment plans are an ideal way to do this -- this is one method by which they can average their cost without trying to time the market and make a lot of money.

You time the market when you try to buy a stock at its lowest price and sell when it is just about to reach its peak. Even the most seasoned stock market players will tell you that this is a near impossible task.

But what if there is a method that can give you superior returns than Dollar Cost Averaging (DCA) even as it takes a similar risk?

This is where **Value Averaging (VA)** comes into the picture.

What is VA?

Value Averaging is a strategy of spending more money to buy mutual fund units when the price is low and less money when the price is high. It is similar to DCA, though it can be more effective. It also requires a more active role from the investor as compared to DCA.

However, there is a difference between the two. In VA, you keep on increasing your investment amount as the value of a mutual fund unit reduces and vice versa.

DCA allows you to invest a fixed amount at a fixed interval (every month). This means you invest the same amount even when the value of a MF unit comes down.

DCA is a safe investment strategy; any financial expert or experienced investor can tell you that. But the problem for this type of investment strategy is that you are sacrificing maximum profit potential in exchange for simplicity, automation and less of an active role by you as an investor. VA, on the other hand, allows you a more active role.

In order to make the VA system work, the first thing you should do is NOT to second-guess (time) the market. You must be able to invest on a regular basis without fail.

Here is how value cost averaging investing works

Take note of the date and the price you paid per unit of a mutual fund scheme. Let us assume you invested \$ 1,000 at \$ 10 per unit. When it is time for the next investment you check the net asset value, NAV, of the fund.

DCA vs. VA

DCA: When you invest using the DCA strategy, you invest a fixed sum every month. The example mentioned below shows that no matter what the NAV, the person would put in the fixed sum of \$ 1,000 every month. With that s/he tries to achieve an average price which would be lower than the price s/he would have paid if s/he would have made a lump sum purchase on day one.

Month	NAV	DCA			VA			
		Amount	Units	Net	Amount	Unit	Net	Investment
		Invested	Purchased	Units	Required	Purchased	Units	Amount
1	10.00	\$ 1,000	100.00	100.00	\$ 1,000	100.00	100.00	\$ 1,000
2	10.50	\$ 1,000	95.24	195.24	\$ 2,000	90.48	190.48	\$ 950
3	13.00	\$ 1,000	76.92	272.16	\$ 3,000	40.29	230.77	\$ 523.81
4	8.00	\$ 1,000	125.00	397.16	\$ 4,000	269.23	500.00	\$ 2,153.85
5	9.25	\$ 1,000	108.11	505.27	\$ 5,000	40.54	540.54	\$ 375
6	10.00	\$ 1,000	100.00	605.27	\$ 6,000	59.46	600.00	\$ 594.59

VA: As shown in the example above, the first thing you need to determine is how much money you want to invest in mutual funds at the end of each period.

Say, in this case, you want a total investment of \$ 6,000 at the end of six months in a mutual fund in such a manner that, at the end of first month, your total investment is \$ 1,000, at the end of second month your total investment is \$ 2,000 (including the \$ 1,000 invested in the previous month and so on).

Then you can break up this \$ 6,000 over the 6-month period. Unlike DCA, which entails putting in \$ 1,000 (or for that matter any fixed amount) every month, the amount invested using VA technique will vary every month. However, the target of investing \$ 2,000 by the end of second month, \$ 3,000 by the end of third month remains unchanged.

Say, in the first month of your VA investment, the cost per unit of the mutual fund that you want to buy is \$ 10 and you are putting in \$ 1,000. This will get you 100 units ($\$ 1,000 / \$ 10$).

Now, assume that the markets did well and the cost per unit increased to \$ 10.50 by the end of your second month. At this time, the value of your investment would have become \$ 1,050

(\$ 10.5 * 100). Now, remember, the total money you need to invest by the end of second month is \$ 2,000. So, you need not put in another \$ 1,000 this month. Your total investment this month will be \$ 950 (your target investment - the value of your investment; i.e. \$ 2,000 - \$ 1,050).

With this \$ 950, you can buy 90.48 units (\$ 950 / \$ 10.50) that will take your total units at the end of second month to 190.48 (100 units in the first month plus another 90.48 units in the second month).

In the third month, let's say the cost per unit of your mutual fund further increases to \$ 13. This will take the value of your investment to \$ 2476.24 (190.48 * \$ 13). So, the amount you need to invest in the third month will be \$ 3,000 (your target as decided in the beginning) less \$ 2476.24, that is \$ 523.76.

With this amount at the end of the third month, you will be able to buy 40.28 units (\$ 523.76 / \$ 13). The total number of units at the end of the third month at 230.76 (190.48 plus 40.28).

Now, let's see what happens when the cost per unit goes down. As per the table in the fourth month, the cost of each unit has gone down to \$ 8. That takes the value of your investment to \$ 1,846 (\$ 8 * 230.76). That means at the end of the fourth month you will have to invest \$ 2153.92 (\$ 4,000 less \$ 1846).

This clearly shows that, in the VA method, you keep increasing your investment amount as the value of a mutual fund unit reduces, and vice versa. This is how it goes on and on till you deem it fit to stop your VA investment. In the example above, we have stopped at the end of the sixth month.

This is the basis on which the VA method works.

	Average Cost	Total cost	Current value	Current gain	% gain
DCA	9.91	\$ 6,000	\$ 6052.70	52.70	0.88
VA	9.32	\$ 5,597	\$ 6,000	403.00	7.20

The table above shows the effect at the end of the sixth month. The total amount invested in DCAs is \$ 6,000 (\$ 1,000 every month) and you get 605.27 units at a price of \$ 9.91 (\$ 6,000 / 605.27) per unit.

But the total amount invested using the VA strategy is \$ 5,597 and you get 600 units at an average price of \$ 9.32 (\$ 5,597 / 600) per unit.

Current value for DCA = \$ 10 (the price at the end of the sixth month) * 605.27 (total units) = \$ 6,052.70

Current value for VA = \$ 10 (the price at the end of the sixth month) * 600 (total units) = \$ 6,000

At the end of the sixth month, the cost of one unit is \$ 10. That will take the value of your DCA investment to \$ 6052.70 (\$ 10 * 605.27) against an investment of \$ 6,000 and the value of your VA investments to \$ 6,000 against an investment of \$ 5,597.

So, the profits made by you investing in DCA is \$ 52.70 (\$ 6,052.70 – \$ 6,000) and the profits made under the VA method is \$ 403 (\$ 6,000 – \$ 5,597).

Profits in per cent made under DCA = ($\$ 52.70 / \$ 6,000$) * 100 = 0.88 per cent and

Profits in per cent made under VA = ($\$ 403 / \$ 5,597$) * 100 = 7.20 per cent

This makes it abundantly clear that your profits have increased at a faster pace via VA method (7.20 per cent), against a mere 0.88 per cent via the DCA method.

As you can see, the majority of shares are purchased at low prices. When prices drop and you put more money in, you end up with more units (this happens with DCA as well, but to a lesser extent). Most of the units have been bought at very low prices, thus maximizing your returns when the time to sell beckons.

If your investment is in a sound fund, VA will increase your returns beyond simple DCA for the same time period. And it does so at a lower level of risk.

Warning: Neither approach will bail you out of a declining market with all your money intact.

All said and done remember this gem from multi-billionaire investor Warren Buffet: The best holding period is forever.