

To Wade or Plunge?

Jeff Troutner of TAM Asset Management coined the terms “wade” and “plunge” for investing a sum of capital slowly over time or all at once. The wading approach has historically been known as dollar-cost-averaging. Proponents of wading view plunging as reckless and argue wading is much more sensible for the risk-adverse investor. Proponents of plunging believe that wading reduces returns more often than it increases them.

To shed some light on the subject, Truman Clark of Dimensional Fund Advisors analyzed wading over 4 quarters versus plunging into domestic portfolios from 1927 through 2003 and into global portfolios from 1970 through 2003. He calculated that plunging beats wading about two-thirds of the time and concluded that wading is a bad bet. He advises, “Come on in, the water is fine.” Certainly this is true for pure statistical probability of return maximization. But that is not how many investors look at it.

Any allocation to “safe” investments reduces expected return. If investors were only interested in maximizing expected return, everybody would allocate 100 percent of their wealth to equities. Some investors have more conservative portfolios because they are willing to give up expected return in exchange for lower risk. A 60 year old who is investing his life savings to provide retirement income over the next 20 or 30 years may not be interested maximizing the probability of achieving the highest return. He may be more interested in making sure he does not run out of money. This investor might gladly accept a two-thirds probability of coming out behind if the one-third of the time he comes out ahead saves him from running out of money.

The statement that plunging beats wading most of the time does not address the concern of the risk-adverse investor. This investor wants to know if wading reduces the chance of running out of money and that is a different question. The fear this investor has is that he will put his money into the market at the beginning of a bad market and dig a hole from which he can never recover. This is a rational fear, but the fact that the fear is rational does not mean wading reduces the risk of this bad result.

To address this fear, we need to define what this fear looks like. For this purpose, we will define it as a 20-year period of poor returns. To begin this analysis, we examined every 240 month period from January 1926 through June of 2004. We compared wading to plunging during these periods assuming 12, 24, 36, 48 and 60 month wading periods in the beginning of the 240 month period. Obviously, tacking on another 228 months onto the end of a 12-month wading period does not change the effectiveness of wading during that period. The purpose of doing that is to put some long-term perspective into the analysis of wading.

Like Truman, we concluded that plunging beats wading over 12 months in 63% of the trials or about two-thirds of the time. We further calculated that versus 24-month, 36-month, 48-month and 60-month wading, plunging wins 66%, 71%, 72% and 73% of the time, respectively.

All this makes sense since equities have had higher returns during most historical periods. Any time you reduce exposure to equities for a portion of the investment period, you are going to reduce returns most of the time. The more (or longer) you reduce exposure, the more often you reduce returns.

So far wading looks like a loser. But we have still not addressed the \$64,000 question: What about the bad 240-month periods? Are the majority of the periods in which plunging wins high return periods? Wouldn't an investor be better off wading into a bad 240 month period?

To see if wading helps during "bad" periods, we restricted the analysis to low return periods. We speculated that if we had a bad start, maybe we would have a bad 20-year period. We began by looking at all 240-month periods with returns of less than six percent for the entire period. Wading was a bit better during these periods, but you had to wade for at least 24 months and did not get a significant advantage until you waded for 48 months.

Unfortunately, though, this is based on only 42 rolling periods all of which occurred for 20-year periods beginning between 1926 and 1930. These 20-year periods have significant overlap so they are essentially variations of one period, and we can really only say it worked once.

To get some more meaningful information, we increased the threshold for "low return" from six percent to eight percent. Doing this increased the periods that met our definition from 42 to 166. For these periods, wading over 12 to 60 months was better in 23% to 35% of the periods. The statisticians reading this will still object to the method. Even with 166 rolling periods there was substantial overlap. These 166 rolling periods were in two groups – periods beginning between 1926 and 1931 and periods beginning between 1954 and 1965.

Therefore, we have not provided statistically significant data to prove that wading does not work in bad periods. However, the analysis done by Truman Clark and repeated by Resource Consulting Group suggested that wading is a bad bet and this data suggests that the bet is not likely to be much better in long periods of low returns.

So does this mean that no one should ever wade under any circumstances? Absolutely not! Investing is not a sterile, clinical exercise of probabilities and statistics. Investing is the process of integrating subjective human factors with objective technical factors to use wealth to further the goals of the investor. Peace of mind is the number one goal for many investors. A new investor who is unsure of his investment policy and nervous about investing would be very wise to wade. Yes, doing so is probably going to reduce his return in the long run and no, it is not likely to reduce the chance that he will run out of money. In fact, it may increase the chance that he will run out of money. However, if it reduces stress and allows him to systematically move toward a sensible long-term plan, it is worth it.

Moreover, these studies all assume the investor stays committed to a consistent investment policy over time. A bit of bad luck in the early years might scare some new investors out of the market. Easing in might be just what it would take to avoid being scared out of the market at a bad time. And some new investors might not be able to get started without easing in. Getting something in the market is better than nothing.

In summary, a totally logical investor interested in investing in the most statistically sensible way would always plunge new money into the market. However, not everyone fits that description and therefore wading can make sense for the right investor for qualitative reasons.