A Systematic Investment Approach

In a post-Lehman era -- termed the "*new normal*" -- investors are more apprehensive about investing, as easy money no longer exists. Some are either beginning to explore ways to time the market, or simply choosing to stow their cash until markets calm down.

Market timing may have worked for a handful but for the majority of investors, consistent gains may have proved elusive as most do not understand the market well enough, nor have the time to monitor the markets full-time, to reap consistent gains. Moreover, even professionals are hard-pressed to make a call on the market's future direction in the current environment.

Limited Opportunities?

So do volatile times mean that investors have limited opportunities to capitalise on market movements? Not exactly. This period of momentary ups and downs in the market is nothing new. We have had our our fair share of these moments during the last decade.

Using the MSCI AC Asia ex-Japan Index as a proxy, we identified two post-crisis periods where Asian markets were moving sideways after recovering from a crisis.

- June 2002 – June 2003: During this period, markets were recovering from the September 11 attacks, but volatility persisted due to the Worldcom scandal which impacted investors' confidence in corporate reporting worldwide. The SARS outbreak in Asia also caused Asian markets to enter a lull period.

- February 2004 – February 2005: This post-SARS recovery period saw a variety of market moving events: the raging war in Iraq, the Federal Reserve raising interest rates and oil prices topping $55 a barrel.

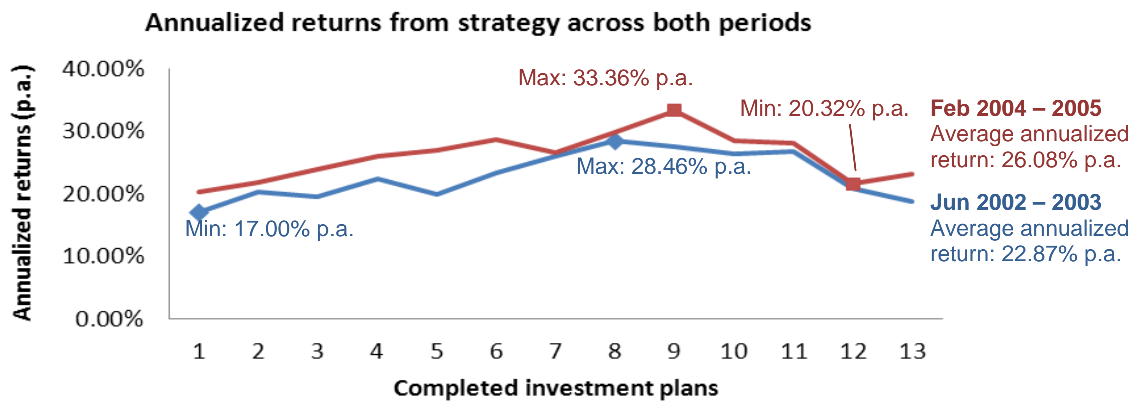
To test our theory, we simulated a drip-feed investment strategy during the two periods, whereby we split a lump sum investment into 6 equal monthly amounts to be periodically invested, and then held over a period of 30 months.This added up to an investment period of 3 years, which is the usual investment horizon for medium to long term investors.

Our simulation is based on the MSCI AC Asia ex-Japan Index, as we believe this index is representative of where attractive investment opportunities are likely to be. Despite some growth concerns in the near term, Asia will remain the key growth driver for the global economy over the coming years. The structural strength of Asian companies and economies should support Asia's growth in the medium to long term.

Based on the Index, the average annualized returns from this strategy across the different lull periods are illustrated in Figure 1. The assumption was that different investors adopted this investment strategy every month during these periods (totaling 13 such plans in each period) and the average annualized returns of these plans were calculated.

As shown in Figure 1, this strategy performed well across both periods identified. The average annualized returns calculated for the June 2002 – 2003 and February 2004 – 2005 periods were 22.87% and 26.08% respectively.

Figure 1



Looking at the results of this strategy over the post-crisis periods identified, it shows that a systematic approach to investing has the following merits over making a lump-sum investment into markets during uncertain times:

- Removes the anxiety of having to decide the "best time" to invest a lump sum into markets.
- Captures entry during downside periods of a lull market, thus lowering average entry levels.
- Allows flexibility to change the periodic investment amounts.

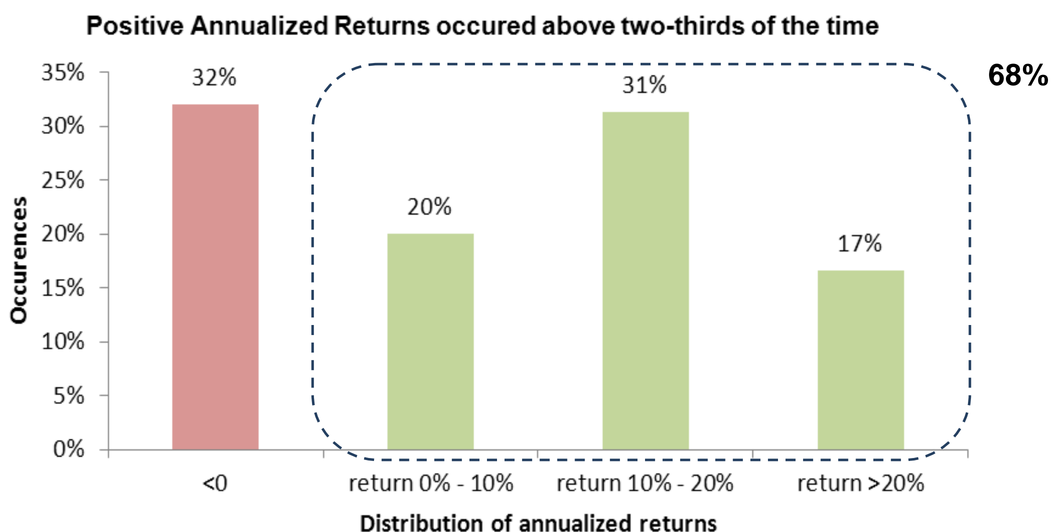
An Investment Approach for All Seasons?

We went one step further to test the effectiveness of such an investment approach at all periods of the investment cycle. Thus, we took the earliest available data of the Index from December 1987 to December 2012, and conducted a back test on the returns from a systematic investment approach.

Only observations which fulfilled the total investment horizon criteria of 36 months were considered. We calculated the annualized returns of each completed investment period, assuming different investors started this investment monthly since December 1987.

Over a 25-year time period, across the different market cycles, this strategy of investing systematically has generated a positive annualized return above two-thirds -- or 68% -- of the time (Figure 2), with an average annualized return of 6.62%. The distribution occurences and range of positive annualized returns are shown below:

Figure 2



Seeking Opportunities in Every Market Condition

So have we found the Holy Grail to investing? No, as no investment strategy is infallible. If the market is visibly in the midst of a bull-run, this approach could potentially generate lower returns relative to investing a lump sum of money during the same period.

But considering the murky road ahead, with no clear directions, investors should ask themselves these questions:

1. Are you willing to put your investment plans on hold in favour of a clear market trend, which is unlikely to emerge in the near term?
2. Are you willing to sacrifice opportunities that you could have taken advantage of, had you adopted a drip-feed investment strategy?
3. Are you willing to expose yourself to unnecessary investment risks by choosing to time the market, thinking you can always outsmart the market?

If the answer to any of these questions be a resounding 'No', then investors should start considering a systematic investment approach. In this way, they avoid missing out on potential opportunities and are well-poised to take advantage of changes in market momentum with moderate risks, while growing their investment over the medium to long term.

Appendix

<u>Key assumptions of strategy</u>

1. The transaction cost is negligible (assumed to be zero).
2. The total investment horizon of 36 months consists of a regular investment of 6 months, and investment holding period of 30 months.
3. The annualized return measures the difference between final value (at the end of total investment horizon) of the investment portfolio and the total initial investment amount, on a per annum basis. The average annualized return is the average value of all such defined annualized returns.
4. The MSCI index markets are liquid.
5. The buying and selling of MSCI Index units is done at the last trading date and last trading price of a given month.

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