

How to Invest a Lump Sum

Description

A lump sum is the stuff of dreams for most investors. It provides an opportunity to carve up a portfolio exactly how they planned and generate the perfect mix of income and capital growth potential. However, deciding exactly how to apportion a lump sum can be tricky, with areas such as timing, volatility and diversity creating potential problems. As such, it makes sense for investors to take their time above all else.

Proceeding cautiously is key to investing a lump sum because volatility can quickly either make or break a portfolio. For example, the S&P 500 dropped by over 5% within one day and gained that amount back the next day in the aftermath of the EU referendum in June 2016. Similarly, global stock markets wobbled in the aftermath of the US election, only to recover strongly. And fears surrounding Chinese growth caused major falls earlier in the year, too, from which most indices recovered.

As such, investing a lump sum in one go can prove problematic. If you had bought shares just before those three falls of 2016, you would be feeling downbeat regarding the outcome in the aftermath. While share prices have generally recovered, an important part of investing is to maintain a focus on logic rather than emotion. Therefore, it is entirely possible that many investors who invested a lump sum just prior to a 5%+ fall would quickly sell their shares in case things got worse. This would lead to losses and a failure to take part in the subsequent recovery.

Therefore, it may be prudent to invest a lump sum gradually, rather than all at once. This provides investors with the capital to take advantage of sharp downturns and benefit from them. It also means that volatility can be used as an ally rather than a potential danger. Furthermore, investors may struggle to find a number of excellent investment opportunities in a short timeframe. As such, investing a lump sum over a sustained period will allow them to focus the same energy on a smaller number of stocks at once, thereby helping them to find the best opportunities for the long term.

In terms of diversification, it is crucial to have a mix of assets within a portfolio. Shares may offer the best long term rewards, but they are also riskier than cash or bonds. Therefore, it makes sense to maintain a degree of liquidity and some protection from the ups and downs of the stock market through holding cash or bonds. Certainly, it may mean that your overall returns are dampened somewhat. However, the peace of mind as well as opportunity to capitalise on future opportunities makes it a sensible step to take.

While the idea of taking a lump sum and piling right into the best available stocks at the present time may sound like a good plan, the reality is that drip feeding cash into a variety of assets over time is a more logical idea. It will help to negate the impact of short term volatility, provide a degree of diversification and allow you the time required to find the best opportunities for the long term.

CATEGORY

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