Independent Investor

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Take the Emotion Out of Investing with Dollar-Cost Averaging

One of the best ways to take emotion out of investing is to create a plan and stick with it. And way to do that is through a systematic investment plan called dollar-cost averaging (DCA).1 Dollar-cost averaging is a process that allows investors to slowly feed set amounts of money into the market at regular intervals

Dollar-Cost Averaging: An Example

As a long-term strategy, one potential benefit of using DCA is that it can help ensure that your money purchases more shares when prices are low and fewer shares when prices are high. Over time, the result could be that the average cost for the shares may be less than the average share price.

Consider the hypothetical example below, which assumes you invest $50 per month in an investment for 12 consecutive months, and every month the share price fluctuates a bit. You can see that your $600 total would have bought you 42.5 shares. The average price per share, as calculated by adding up the monthly prices and dividing by 12, would have been $14.25. However, the average cost, as calculated by dividing the total amount invested by the number of shares, would have been $14.12 per share. Over the years, this method could potentially save you a lot of money.

Month	Share Price	Shares Bought
Jan	$15	3.3
Feb	$13	3.8
Mar	$12	4.2
Apr	$14	3.6
May	$13	3.8
Jun	$12	4.2
Jul	$13	3.8
Aug	$14	3.6
Sept	$16	3.1
Oct	$16	3.1
Nov	$17	2.9
Dec	$16	3.1
Total Shares:		42.5
Average Price Per Share:		$14.25
Average Cost Per Share:		$14.12

Source: DST Systems, Inc. This example is hypothetical and for illustrative purposes only. Some quantities are rounded. Your results will vary.

Other Long-Term Benefits of DCA

In addition, DCA can potentially offer the psychological comfort of easing into the market gradually instead of plunging in all at once. Although DCA does not ensure a profit or protect against a loss in declining markets, its systematic investing "habit" helps encourage a long-term perspective, which can be soothing for people who might otherwise avoid the short-term volatility of the riskier, but potentially more profitable, investments such as stocks.2

And last, DCA may help you make savvy investment decisions if you stick with it. For instance, if your investment rises by 10%, you will likely post gains because of the shares you've accrued over time. But if your shares decline by the same amount, take comfort in knowing that your next investment will purchase more shares at a lower price per share.

Lump Sum Investing Versus DCA

Although investing a regular amount each month may be a sound way to develop a regular investing habit, some experts say that it may not be the best way to manage a lump sum of money, such as a 401(k) distribution, a bonus, or an inheritance.

As an example, consider the following situation: If you are 65 years old and you receive a $300,000 401(k) distribution and immediately reinvest the entire sum, can you afford to take a chance that the market will drop shortly thereafter? If there's a sustained market decline, you might be left with a nest egg that is somewhat smaller than you had originally planned on. Over time you might recover your investment, but you have to weigh the consequences of a potential loss before choosing lump sum investing over DCA. Also, remember with lump sum investing the money does not earn anything if it is not invested in the market.

Regular Investing Makes Sense

As a long-term strategy, you may find DCA allows you to feel more comfortable during uncertain markets than the lump-sum investing approach because it eliminates much of the guesswork -- and emotion -- associated with investing. In addition, DCA can help investors take advantage of the market's short-term price fluctuations in a systematic way -- by automatically buying more shares when prices drop and fewer shares when prices rise.

[1]Dollar-cost averaging involves regular, periodic investments in securities regardless of price levels. You should consider your financial ability to continue purchasing shares through periods of high and low prices. This plan does not ensure a profit and does not protect against loss in any markets.

[2]Investing in stocks involves risks, including loss of principal.