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Lump-Sum Investing vs. Periodic Investing

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Introduction

Whether to invest a large amount all at once or over a short period of time (lump-sum investing), or to invest gradually over a longer period of time (periodic investing) is an investment strategy decision you'll have to face if you're fortunate enough to have a lump sum available to invest. Would it be better to put money into the market a little at a time or to invest it all at once? Both approaches have benefits and drawbacks, and the investment community is split regarding which is best.

Lump-sum investing

When is lump-sum investing sometimes used?

You may be considering lump-sum investing if you received a large amount of cash all at once--for example, from an inheritance, as a gift or a court settlement, by selling a real estate holding, or by winning the lottery. In some cases, if you are financially well-off, you also may have a lump sum to invest immediately--for example, the proceeds of a bond or certificate of deposit that has matured.

The advantages

The quicker you get your money into the market, the more time that money has to grow. Anytime you hold money aside, you are shortchanging your investment plan (this is known as opportunity cost). Lump-sum investing could be beneficial to you as long as the time horizon for the investment is sufficiently long (10 years or more). Several U.S. studies over several decades (Richard Williams and Peter Bacon, "Lump Sum Beats Dollar Cost Averaging," Journal of Financial Planning, April 1993; G.M. Constantinides, "A Note on the Suboptimality of Dollar-Cost Averaging," Journal of Financial and Quantitative Analysis, June 1979; John Knight and Lewis Mandell, "Nobody Gains From Dollar Cost Averaging," Financial Services Review, 1992) reviewed overall stock market performance and reached a similar conclusion: the longer your time frame, the greater the odds that a lump-sum investment will outperform dollar cost averaging.

Also, in some cases, you may be able to minimize transaction costs by investing a large sum all at once rather than making multiple purchases over time.

The disadvantages

Lump-sum investing can be problematic because of the risk associated with it. For example, what if you invested the entire sum in the stock market just before it went into one of its periodic declines? In such a case, there is no assurance you will recover the original value of your money, and if the decline is dramatic, recovery could take a very long time. Investing at what turns out to be a market peak can substantially affect long-term returns. That's one reason it's best to have a long time frame for a lump-sum investment in a potentially volatile asset class; you have a longer window of opportunity to ride out such fluctuations.

Also, the idea that it's better to put your money to work sooner rather than later is based on the long-term historical behavior of the stock market since record-keeping began in 1926. That doesn't mean the markets will behave in the future as they have in the past, or that there won't be extended periods in which stock prices don't rise. Even if they do move up, they might not do so immediately and forever once you invest.

Other considerations

Receiving a lump sum can be overwhelming. What do you do with it and when? These are important questions; you don't want to underestimate their significance. Don't feel you have to make a decision immediately. Think about how this sum will affect your portfolio; should you reallocate assets or simply follow the same asset allocation pattern? Take your time. You can even invest some of the money immediately and think about how to invest the rest later.

Periodic investing

In general

Periodic investing is a strategy of making regular investments on a regular basis, such as monthly, quarterly, or yearly. There are several forms of periodic investing, but they all have the same goals: (1) to make investing automatic and eliminate the need to "time" the market, (2) to smooth out fluctuations in market prices, and (3) to reduce the risk and impact of a loss associated with a sudden downturn in the market.

Periodic investing can work well over time. It is particularly useful for investors with small streams of discretionary savings who want long-term investments.

Dollar cost averaging

The most common form of periodic investing, dollar cost averaging involves making investments of a fixed amount at set intervals. You invest the same amount of money each time.

Since each installment involves investing the same amount of money, dollar cost averaging automatically buys more shares of a security when the share price is low and fewer shares when the price is high. Over time, this strategy lowers your average price per share.

The following table illustrates how share price fluctuations can yield a lower average cost per share when you invest the same amount regularly.

Regular Investment	Price Per Share	Shares Purchased
$200 (each month)	$25	8
$200	$20	10
$200	$10	20
$200	$20	10
$200	$25	8
$1,000 Total	Average Price = $20	56 Total Shares

In this example, the average market price over the five-month purchasing period is $20 per share ($25 + $20 + $10 + $20 + $25 = $100 divided by 5 = $20). However, because the regular amount of the monthly investment buys more shares at the lower share prices, the average purchase price of actual shares purchased is $17.85 ($1,000 invested divided by 56 shares purchased = $17.85). Note: This example is for illustrative purposes only and does not represent any particular investment.

However, dollar cost averaging can't protect you from a loss, particularly in a declining market, nor can it guarantee that your investment will realize a gain. To reap the full benefits of this strategy's ability to lower your average cost per share, it's important to continue investing through periods of market decline. For this reason, dollar cost averaging is most suited to the pursuit of long-term investment goals, such as saving for your retirement in an IRA or a 401(k). If you're seeking investment gain over a shorter term, dollar cost averaging will be less effective than lump-sum investing, provided the market is rising consistently.

Value averaging

Value averaging is a more complex variation of dollar cost averaging. Rather than dictate (as dollar cost averaging does) a specified amount that's to be invested at each transaction interval, value averaging proposes a fixed increase in the total value of your investment as the target to pursue with each periodic transaction. At each interval, you determine the value of your portfolio. You then buy additional shares (if the total value of your portfolio is below the proposed investment target at that point) or even sell existing shares (if the total value of your portfolio exceeds the investment target) as needed to adjust the total portfolio value to the new target. For each transaction period, you'll know the target you want to reach; what's unknown (until you determine the portfolio value) is how much or little additional funding (if any) you'll need to provide to get there.

In the example illustrated above, the dollar cost averaging strategy was to invest $200 per month. The value averaging strategy would instead seek to increase the portfolio's total value by (for example) $200 per month. In months when the total portfolio value has declined, you'll need to buy that many more shares to make up the difference. When the value of the portfolio increases, you'll need to buy fewer (if any) shares to bring the total portfolio value to the desired level. In fact, if the share price increases sufficiently, you may need to sell shares to maintain your portfolio's value at the desired target level.

Here is an illustration of the value averaging strategy:

Month	Current Share Price (a)	Total Shares Owned (b)	Total Current Portfolio Value (c) = (a x b)	Total Portfolio Value Required (d)	Shares Bought/(Sold) To Reach Total Portfolio Value Required (e) = (d - c)/a	Cost of Shares Bought/(Sold) (a x e)
1	$25	0	$0	$200	8	$200
2	$20	8	$160	$400	12	$240
3	$10	20	$200	$600	40	$400
4	$20	60	$1,200	$800	(20)	($400)
5	$25	40	$1,000	$1,000	0	$0

In this example, the total (net) cost of the value averaging strategy is $440, making the average cost per share (the total net cost divided by the number of shares held at the end of the fifth month) $11. The average market price per share during the investment period is $20. Note: This example is for illustrative purposes only and does not represent any particular investment.

Value averaging requires you to buy more shares when your total portfolio value is below your investment target and to sell shares when your portfolio value exceeds your target. As with dollar cost averaging, this strategy will over time reduce your average cost per share, and your average cost per share will always be less than the average market price per share for the time period during which you're investing.

However, as with dollar cost averaging, value averaging can't protect you from a loss, particularly in a declining market, nor can it guarantee that your investment will realize a gain. To reap the full benefits of this strategy's ability to lower your average cost per share, it's important to continue investing through periods of market decline. Achieving the goal of increasing the total value of your portfolio, especially in a declining market, may sometimes require a substantial periodic investment of new capital.

Because it requires the frequent revaluation of your portfolio and irregular (and sometimes significant) periodic contributions to pursue your target goals, value averaging may not be an ideal investment strategy to pursue within retirement investment vehicles such as IRAs or 401(k)s. However, you may wish to consider a value averaging strategy to fund a goal that requires you to have available a specified amount by a certain date (e.g., your child's college tuition in 15 years).

Combination strategies

Some strategies exist that combine lump-sum investing with dollar cost averaging. The "proportional allocation" method calls for a lump-sum investment to be made immediately, followed by monthly or quarterly additions. The "increasing with market declines" method calls for employing a straight dollar cost averaging strategy unless the market declines by a certain percentage. When it does so, the rate of investment accelerates. In other words, when the share price of a security drops, a larger investment is made in an effort to buy more shares at the lower price.

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