PERSONAL FINANCIAL SERVICES
SINCE 2001

What is dollar cost averaging?

If you are an investor looking to follow a preset approach so that you are not exposed to wild market swings, you might want to consider a dollar-cost averaging strategy. Dollar cost averaging provides a straight forward way to prudently grow and manage your wealth, particularly if holding a significant amount of cash and investing for the first time, without being overly concerned by prevailing market volatility.

How does it work?

Dollar-cost averaging involves making regular incremental investments over an extended period. While the price of the asset you are buying may go up and down over that period, you are always investing the same amount.

Over time, you end up buying more of the asset when prices fall and less when the price is high. Over the total period you are investing, your average entry cost into specific assets will potentially be lower than the prevailing market price.

It provides a straight forward way for you to steadily accumulate wealth, avoiding the need to actively pick the lows or highs of the market, reducing the emotional component of investing. It aims to reduce the impact of volatility on large purchases of financial assets such as shares or managed funds by investing a regular fixed dollar amount regardless of market trends.

By not investing all your money on day one, you decrease the chance of overpaying. Over time, as assets are acquired at regular intervals at various prices – you get the average price – not a high price or a low price.

How is it calculated?

To understand how dollar-cost averaging can benefit you, we need to compare it to other possible buying strategies, such as purchasing all your holdings in one lump sum transaction. Below are a few scenarios that illustrate how it works.

Scenario 1 – lump sum purchase

Mae invests $100,000 in a single transaction. At $2.50 per unit, she acquires 40,000 units. Let's compare it with other scenarios to see how dollar-cost averaging works.

Scenario 2 – falling market

Mae invests $25,000 every quarter over the course of a year for a total investment of $100,000. During this period, unit prices have steadily fallen.

Date	Unit Price	Investment	Units purchased
1/01/2020	$2.50	$25,000	10,000.00
1/4/2020	$2.30	$25,000	10,869.57
1/7/2020	$2.20	$25,000	11,363.64
1/10/2020	$2.00	$25,000	12,500.00
	Total	$100,000	44,733.21

By the end of 12 months, Mae has acquired an additional 4,733.21 units compared to the lump sum scenario.

Scenario 3 – rising market

Using the same investment approach as the above, during this period unit prices have instead steadily increased.

Date	Unit Price	Investment	Units purchased
1/01/2020	$2.50	$25,000	10,000.00
1/4/2020	$2.30	$25,000	9,615.38
1/7/2020	$2.20	$25,000	9,433.96
1/10/2020	$2.00	$25,000	8,928.57
	Total	$100,000	37,977.91

In a rising market, she has acquired 2,022.09 fewer units compared to the lump sum scenario.

In this scenario, dollar-cost averaging has kept Mae from maximizing her gains relative to the lump sum scenario. As the unit price increases, she is acquiring fewer units. In the short term, dollar-cost averaging appears to be a disadvantage.

Scenario 4 - Investing for a longer term

Mae invests $10,000 every month over the course of 10 months for a total investment of $100,000. During this period, markets have risen and fallen.

Date	Unit Price	Investment	Units purchased
1/01/2020	$2.50	$10,000.00	4,000.00
1/02/2020	$2.47	$10,000.00	4,048.58
1/03/2020	$2.44	$10,000.00	4,098.36
1/04/2020	$2.40	$10,000.00	4,166.67
1/05/2020	$2.41	$10,000.00	4,149.38
1/06/2020	$2.37	$10,000.00	4,219.41
1/07/2020	$2.22	$10,000.00	4,504.50
1/08/2020	$2.35	$10,000.00	4,255.32
1/09/2020	$2.50	$10,000.00	4,000.00
1/10/2020	$2.70	$10,000.00	3,703.70
	Dollar Cost Average	Total investment	Total units purchased
	$2.44	$100,000	41,145.92

By implementing dollar-cost averaging over a longer investment period, Mae's average unit price is $2.44. Compared to the lump sum scenario, Mae has acquired an additional 1,145.92 units without having to time her investments with market movements.

Overall, dollar cost averaging has had the effect of 'smoothing' out the unit price over time and helped Mae avoid investing a significant amount at a high point for prices.

Benefits

Using a dollar-cost averaging strategy generally lowers your average unit price in an investment over time.

It can be an effective way to invest for the long term as it is a simple yet disciplined approach that can help avoid the temptation to 'time the market' and may help reduce the impact of volatility.

By sticking to a schedule, it becomes easier to ignore the market as you continue to make consistent investments into it.

In the long run, if you use a dollar-cost averaging strategy you are assuming that the simplicity of the strategy, combined with the fact that it protects you from the temptation of buying high and selling low, will ultimately lead to better results than trying to time the market with each purchase.

It makes investing convenient and easily accessible. Generally, it's difficult for people to accumulate a large lump sum of money to invest, however you may be able to afford a moderate regular investment.

Risks and other important things to consider

There is a trade-off between risk and return. If you want the chance at better returns, you have to accept a larger risk of not receiving them. The same is true with dollar-cost averaging. Although it can lead to better returns in some cases, it is not guaranteed.

When market prices are trending upwards, if you invest a lump sum earlier, you are likely to do better than smaller amounts invested over a period. In this case, a lump sum investment will provide a better return over the long run because of the market's rising conditions.

It's important to note that over a period in which prices fall steadily, a dollar cost averaging portfolio will still lose money. Nevertheless, in which case, dollar cost averaging will generally lose less than a lump sum purchased portfolio.

One of the biggest pieces of an investment plan is your asset allocation, which is essentially how you choose to divide your money between high-risk, high-return investments like stocks and low-risk, low-return investments like bonds.

Whatever your asset allocation, dollar- cost averaging may over time change the proportion of assets you hold in high-risk, high-return investments. Regularly reviewing your investments and working with a financial adviser can help ensure your high-risk, high-return investments are maintained at level appropriate to your circumstances.

The dollar cost averaging strategy is typically associated with passive investing strategies as you may want to minimize the time spent in administering your portfolio. By adopting a passive approach through the establishment of a regular scheduled investment, you will not be responding to the changing environment. If you are an experienced investor, you might be able to get better returns by active management instead of dollar-cost averaging.

Buying assets more frequently adds to trading costs. If you're investing longer-term, costs associated with dollar-cost averaging should become small relative to your overall portfolio. You're buying for the long haul, not trading in and out of the market regularly.

You may forego gains that you otherwise would have earned if you had invested in a lump sum purchase and the stock rises shortly after. However, the success of a large purchase relies on timing the market correctly and it is difficult to predict short term movement of a stock or the market. If a stock moves lower in the near term, dollar-cost averaging means you should come out ahead of a lump sum purchase if the stock moves back up.