

Dollar cost averaging explained

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Dollar cost averaging is simply the term used to describe the strategy of making regular incremental investments over a period of time as opposed to a one-off lump sum investment.

The theory behind this strategy is that you can reduce the market timing risk of investing your entire portfolio in a single transaction on what might be an expensive entry point. In other words, if you invest a lump sum on a day when the market is up you will purchase a lower number of units compared to a day when the market is lower. By adopting a dollar cost averaging strategy you can spread out your investment entry points and potentially achieve a lower average cost base, which means you purchase a greater number of units for the same (investment) amount.

Dollar cost averaging is most effective when markets are on a downward trend. In a rising, or bull, market environment, a dollar cost averaging strategy is not as effective; obviously the lump sum investment would be optimal on the day when the price was lowest – the fundamental principle of buy low, sell high... but how do you know when that day is?

Effectively, all working Australians practice a dollar cost averaging strategy within their superannuation accounts. For most of us, each month, our employers contribute 9.5 per cent of our salary to superannuation. The decision to actively choose to implement a dollar cost averaging strategy arises for investors who need to restructure investments to manage a new stage of life or perhaps due to an abnormal receipt of funds such as an inheritance.

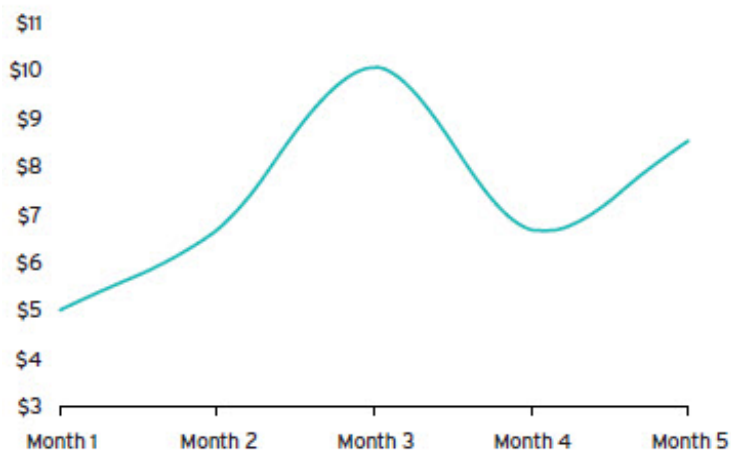
The success of a dollar cost averaging strategy will depend upon the future returns from the investment.

Case study

Let's look at a simple example of dollar cost averaging in action. The table below shows how someone who invests \$200 every month for five months will pay different amounts for each unit as the market price changes. Over the whole period of five months the average cost per unit was \$7.37 so not the lowest or the highest price that the units cost during that time. Dollar cost averaging helps reduce the risk that the timing of a purchase coincides with the price being particularly high. The table also shows the best and worst cases achieved if the total purchase was made all at one time instead of being spread out:

| Month | Investment (\$) | Unit price (\$) | Units purchased |
|---------|---|--------------------------|-----------------|
| Month 1 | 200 | 5.00 | 40 |
| Month 2 | 200 | 6.67 | 30 |
| Month 3 | 200 | 10.00 | 20 |
| Month 4 | 200 | 6.67 | 30 |
| Month 5 | 200 | 8.50 | 24 |
| | | | |
| | Average purchase price = | 7.37 | 144 |
| | | | |
| | Dollar cost averaging strategy | Total cost of investment | \$1,000.00 |
| | | Value at end of period | \$1,220.00 |
| | | Profit | \$220.00 |
| | | | |
| | Worst timing of purchase (Month 3) | Total cost of investment | \$1,000.00 |
| | | Units @ month 3 | 100 |
| | | Value at end of period | \$850.00 |
| | | Loss | -(150.00) |
| | | | |
| | Best timing of purchase (Month 1) | Total cost of investment | \$1,000.00 |
| | | Units @ month 1 | 200 |
| | | Value at end of period | \$1700.00 |
| | | Profit | \$700.00 |

Unit Pricing Example



In summary, a dollar cost averaging strategy can be an effective way to invest over the long term, however, there are market environments which would better suit lump sum investing.

For a long term investor, the decision should be about time in the market **not** timing the market. Perhaps the decision to invest a lump sum over a longer period of time should be based on your appetite for risk. If you can tolerate short term price volatility in favour of longer term gains, you may consider making lump sum investments during low entry points. Many investors, however, remain cautious on short term price volatility regardless of the long term investment horizon and gain more comfort from slowly deploying funds into the market to average out the entry point. The secret to successful investing is time in the market, rather than timing the market.

Ask your Bridges financial planner for more information.

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