When Dollar Cost Averaging Matters the Most

You'd be forgiven if you saw the recent all-time highs of the US stock markets and thought the gains we've seen in 2020 are not sustainable.

In fact, amid mounting unemployment, continued economic intervention by governments around the world, the Bank of England, the Federal Reserve and others, and a staggering death toll from a life-altering virus, the stock market seems to be completely disconnected from reality.

With the number of virus cases apparently rapidly rising again (as of mid-September 2020), the talk of another full lockdown in many countries is in the air and becoming a real possibility. This could, of course, mean that a correction in stock markets will happen for the second time this year.

Which will bring to the fore a regularly asked question;-

"Why should I continue to keep investing if the stock market is falling?"

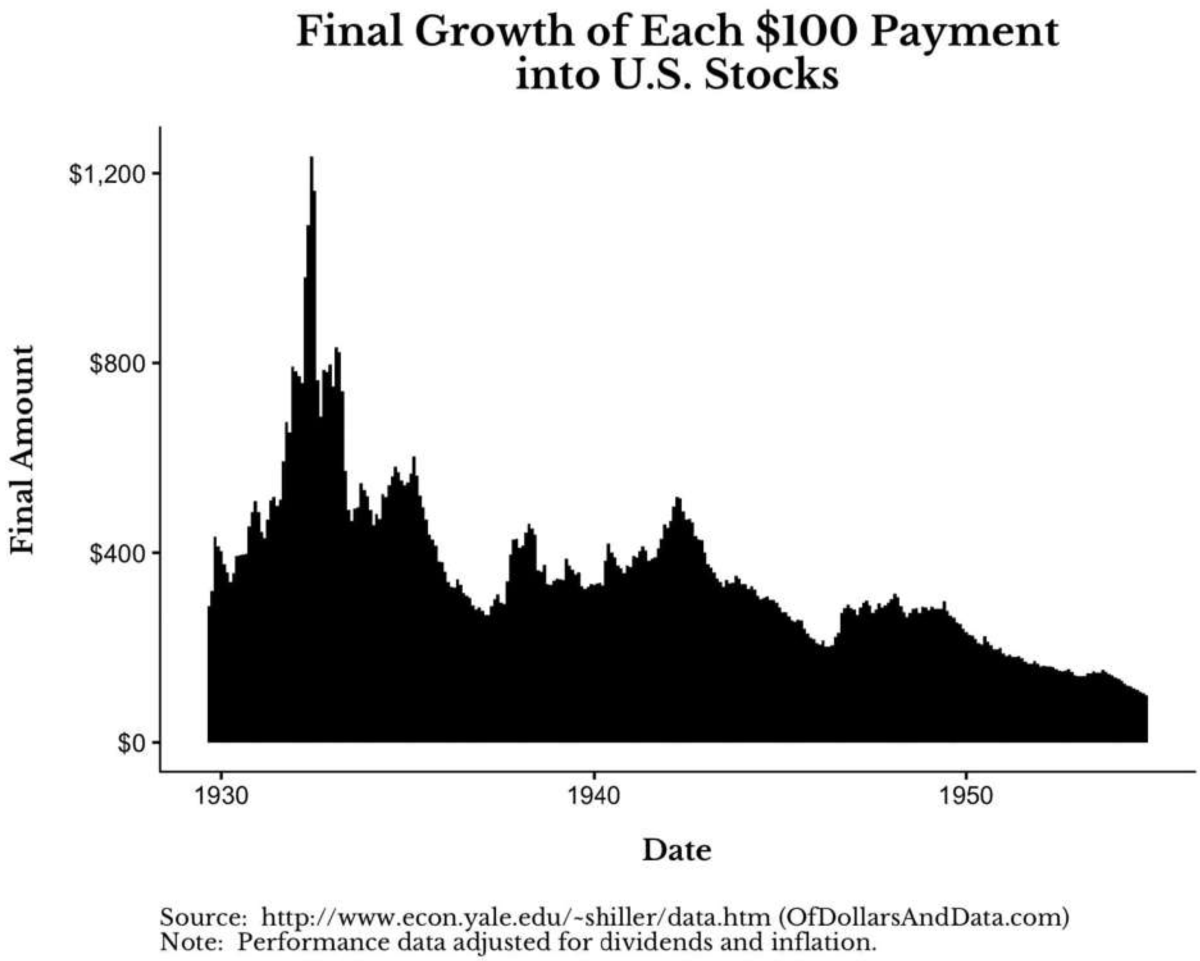
The reason that you should continue to keep investing is quite simple - The contributions you make into the stock market during a market fall will invariably be the best purchases you ever make. To explain why, history gives us couple of examples;-

Courtesy of number-cruncher extraordinaire Nick Maggiulli, the COO of Ritholz Wealth Management in New York, here are two market crashes, and the subsequent value of regular investments made during these times using a 'Dollar Cost Averaging' investment strategy.

1. The 1930's Stock Market Crash

For this example, let's imagine that you decided to invest $100 every month into U.S. stocks from September 1929 to November 1954 (i.e. the 1929 crash and recovery).

If you were to follow such a strategy, here is what each $100 monthly payment would have grown to (including dividends and adjusted for inflation) by the time U.S. stocks recovered in November 1954:

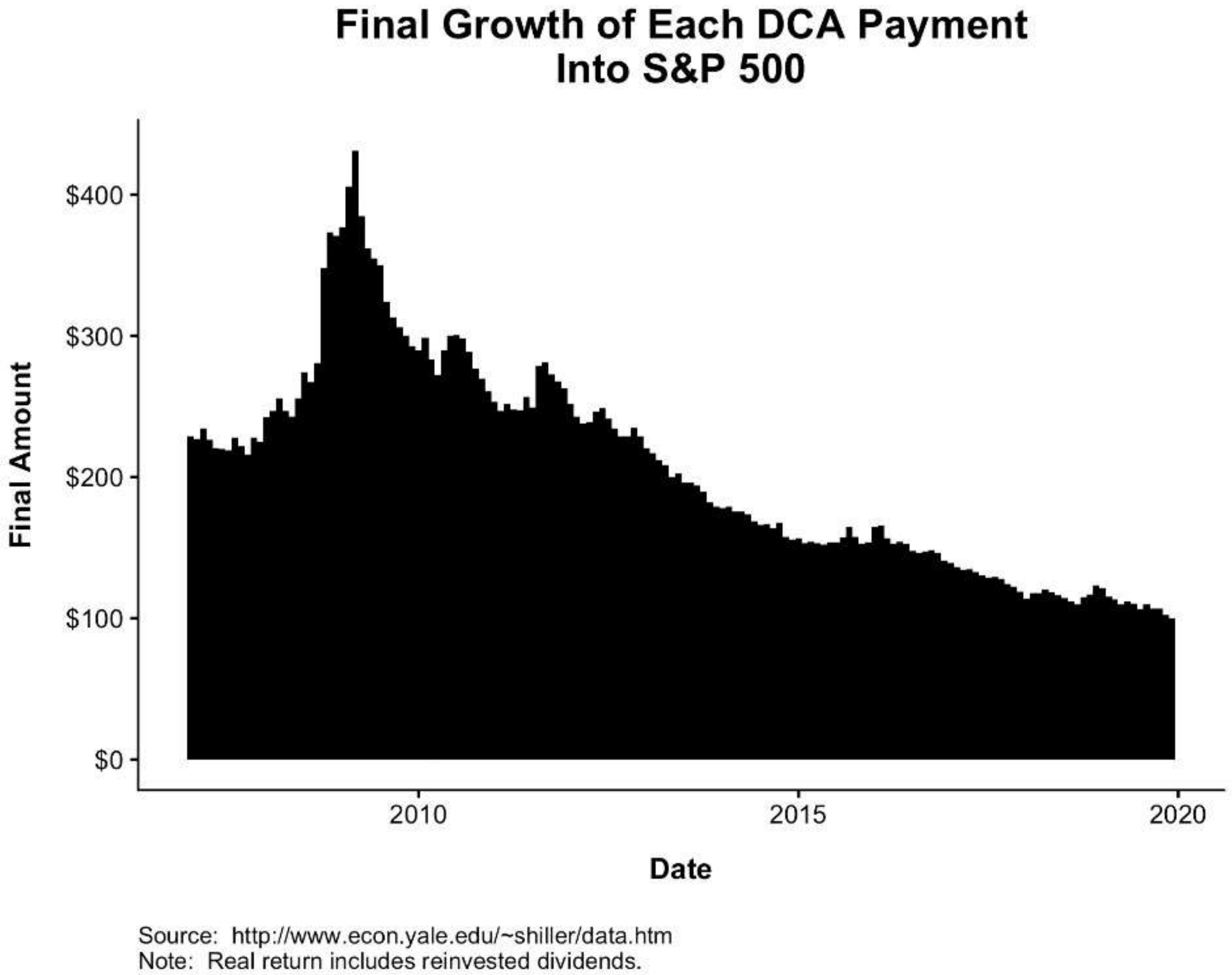


As you can see, the closer you bought to the bottom in the summer of 1932, the greater the long-term benefit of that purchase. Every $100 invested at the market low points would grow to $1,200, which is 3x greater than the growth of a $100 purchase made in 1930 ($400).

This graph clearly demonstrates that buying nearer the bottom usually provides 50-100% in additional growth compared to investing during other periods. This means that your same $100 would grow to $150 or $200 (adjusted for inflation) by the time the market had recovered.

2. The 2008 Stock Market Crash

Again, let's determine what the ending balance of each individual $100 monthly contribution into the S&P 500 would look like, starting in 2007, just before the crash in 2008.



For both examples, look at how much higher the ending dollar amounts are on all of those contributions that cluster around a financial crisis.

Even the contributions made that were too early or too late in relation to the very bottom of the market look great in terms of their growth compared to what the average growth over the period.

Those contributions have had longer to run than the more recent purchases, but that's the whole point! Even those who were fast approaching retirement at those times of the examples could still see their contributions grow for the next two to three decades - Depending on their lifespan of course.

There is also the fact that "waiting until the dust settles" is a strategy that has never worked in the history of the markets.

The real benefit of 'dollar cost averaging' is you don't need to nail the bottom in order to succeed. Simply continuing to invest while stocks are far below where they were five weeks ago is much easier than trying to time the bottom of the market.

Some people will be forced to cut back on retirement savings during this difficult time - And there's nothing wrong with that if you have no other options. Family finances are more important than the stock market at a time like this.

But for those who have the ability to continue making regular investment contributions towards their retirement or other investment goals, there's no need to wait for the dust to settle. Buying periodically when stocks are down is a good thing.

In fact, anyone who is saving should hope the market goes lower or stays where it is for a while to continue buying while share prices are low.

I know that contributions will always feel better when stocks are rising but the reality is that you get the biggest return on your regular investments when prices are falling.

That's the silver lining for investors who are investing a small amount on a regular basis.

Every dollar, pound or euro you invest when the markets are down will grow to far more than one invested in the months prior when the stock market is rising - Assuming that the market eventually recovers…

And of course, history tells us once again that it always does recover.

It is often the case that trying to be too smart when it comes to guessing the markets can be your downfall.

Of course, should the markets take a substantial hit again due to the 'second wave' of Covid-19 cases around the world, you may think about taking your money out of the stock market or halting any regular payments. Don't!

Despite the seemingly obvious upside to continue investing during a stock market crash, many investors are afraid to do so, and this seems to be partially an issue of confidence. However, many people confuse possibility with probability and the two are almost exact opposites.

Please try to keep this in mind if there are additional challenges in the coming months.

Unfortunately, many investors won't keep it in mind. They won't be persuaded by logical arguments in an investment game that is drowned in emotion.

Time to plug yourself into my final piece of logic to try and drown out the emotion :)

Remember that even major stock market corrections such as the Great Recession appear only as blips on a long-term chart, and recoveries happen far more quickly than you might imagine. You only have to look back 6 months for evidence of that!

The logic (and the reality) is that these corrections are rather inconsequential in what otherwise is an exponential curve from the lower left to the upper right of a chart over the longer term, even if they don't exactly feel that way in the moment.

Rather than investing based on emotion, intuition, or pure luck, someone who use the 'dollar cost averaging' strategy invests at pre-planned times. As you can see, this can be a particularly helpful strategy when the stock market goes down.

Had you 'dollar cost averaged' your investment approach back in March this year, you might not have invested exactly at the bottom, but you would have invested throughout the correction. Even if you had bought an index that tracked the S&P 500 at the worst time to buy in March (well before the market hit bottom), right now you would still be sitting on returns of more than 13%!

Dollar-cost averaging can allow you to sleep at night without agonising over the day-to-day fluctuations of the market.

So, if there is another market crash and you are thinking of stopping any regular payment plans, before you head to your computer and press any buttons, here's the advice of an old sage…

"Take both your hands and firmly sit on them".