Dollar Cost Averaging

I suspect that every one of us over the age of 21 has listened as a financial adviser has explained the virtues of Dollar Cost Averaging for regular savings, but what is it and does it work? - Or is it better to time the market?

Dollar Cost Averaging vs. Market Timing

Dollar cost averaging is the regular investment into funds or stocks, while market timing refers to investment decisions based on market conditions.

These strategies can be used to determine how and when an investor allocates his cash into stocks, mutual funds and other financial assets. The choice of an investment strategy is important because it affects a portfolio's overall return on investment.

Dollar Cost Averaging

Dollar cost averaging simply means investing the same fixed amount of money at regular intervals, usually monthly.

The main advantage is that investors could buy more assets at lower prices than at higher prices.

For example, if an investor buys $100 worth of a fund each month, and the fund price ranges between $10 and $20, he avoids the risk of buying the fund at its peak price if he were to make one lump-sum investment.

The downside to dollar cost averaging is that investors would have no opportunity to buy additional shares at lower prices if the markets are in a prolonged bull market, and his fund price is continually rising.

However, a sharp market correction or a sustained bear market could allow investors to reduce the average cost of holding financial assets through dollar cost averaging. Furthermore, once the fund units are purchased, the unit price will move up and down as the fund follows its market.

Market Timing

Market timing involves entering and exiting investment positions based on current or historical market trends.

Using a combination of technical indicators and external (financial news) indications, to attempt to maximize returns by exiting weakening and entering strengthening positions.

For example, if technology funds are underperforming the market as a group, market timers may switch from tech to outperforming groups, such as mining or consumer equity funds. If the stock markets are in turmoil, investors may move into bonds and switch back to equity funds when markets stabilize.

The main advantage of the market timing strategy is that an investor can generate above-average returns if she gets her timing right.

For example, investors who sold just before the 2008 financial meltdown and bought at the market lows in early 2009 would have generated substantial returns.

However, the disadvantage of this strategy is that success depends on accurately predicting market peaks and troughs, which is impossible to achieve reliably. Indeed, very few investors came out of 2008 unscathed!

Combinations

Investors could use a combination of the dollar cost averaging and market timing strategies.

A couple of possible combinations are:- Investors could invest more money following a negative month in the markets and less following a positive month, thus benefiting from a lower average dollar investment cost.

Conversely, investors could follow prevailing market trends and invest more following a positive month and less following a negative month, thus profiting from market momentum.

This however, does assume that your regular savings product allows this variation in monthly contributions, or that you are comfortable with your investment account holding cash until you see the opportune month for additional investment.

Conclusions

Dollar cost averaging is a passive strategy that does not require investors to monitor markets for buying and selling opportunities.

However, if the investor is investing regularly from income, this really implies the cash is only available monthly on an on-going basis, so Dollar-cost-averaging is happening automatically.

Don't be tempted to redirect monthly investment into less volatile funds in a bear market- stick with the volatile funds to ride them back up. But do be aware that the upturn can be quick and dramatic, or take a long patient wait before it happens!

Market timing does require constant attention to market movements, and there will be times when the indicators suggest the investor 'sits on cash' or switches to other market sectors.

If the indicator is wrong, you will miss the boat, so when DO you buy into a bull market?

Equally, at what point in the downturn do you move out of a falling fund? And will that fund turn around quickly and dramatically, leaving you behind and sitting on cash? As the infamous quote goes,- time in the market is better than timing the market.

Neither of these strategies can prevent portfolio losses in prolonged bear markets, or when the underlying fundamentals of financial assets deteriorate. It gets even more difficult to determine market patterns when politics, rather than real market conditions are at the fore.

In essence, if you have money to invest - invest it, diversifying the portfolio with your investment selections. Time in the market is better than timing the market.

If you are investing regularly because you have available cash regularly, let Dollar-Cost-Averaging do it's thing for you, and do not be tempted to stop or reduce the monthly contributions.

For more information, or advice on how dollar Cost Averaging can help to improve your personal financial situation, do not hesitate to contact me.