BOOKMARK

Minimize Investment Risk

Buying stocks carries a higher risk than keeping your money in a savings account or buying U.S. Treasury bonds. There are many ways to manage the risk of investing in the stock market. One method is called dollar cost averaging.

You may have heard the strategy, "Buy low, sell high," when dealing with investing. This is a great idea, but in practice is almost impossible to do. With the fluctuations in the market, your best bet is to always be buying. The idea behind regularly purchasing shares of a security is called dollar cost averaging.

Overview

Dollar cost averaging requires investing the same amount of money on a regular basis, usually monthly or quarterly, regardless of the share price of the stock you are buying. By using this simple discipline, you are smoothing the market fluctuations by averaging out your investment costs. If you invest only when the market is up because you feel optimistic about the future, your dollars are purchasing fewer shares. However, by purchasing when the market is down, your dollars will buy you more, giving you a bargain price. So why not only purchase when the market is low? For years investors have been trying to do this, and they can't. For you to attempt this would do nothing but give you a huge headache and probably hurt your financial status. Dollar cost averaging would eliminate the necessity of timing the market by providing you with a lower average cost per share, and also rewarding you with more shares of a given security.

How Dollar Cost Averaging Works

As an example, let's say you have set aside $12,000 to invest during the next year. You can choose either to invest it all at once, or in smaller amounts over the course of the upcoming year.

If you choose to invest it all at once, your $12,000 might grow like this:

Month	Amount Invested	Price Per Unit	Units Purchased	Value
January	$12,000	$14.93	804	$12,000
Year-end value	$12,000	$16.39	804	$13,177.56

If you chose to invest over the whole year in smaller amounts, your investment may look like this:

Month	Amount Invested	Price Per Unit	Units Purchased	Value
January	$1,000	$14.93	67	$1,000
February	$1,000	$16.95	59	$2,135.70
March	$1,000	$16.13	62	$3,032.44
April	$1,000	$14.08	71	$3,646.72
May	$1,000	$12.05	83	$4,121.10
June	$1,000	$12.05	83	$5,121.25
July	$1,000	$10.99	91	$5,670.84
August	$1,000	$12.99	77	$7,703.07

September	$1,000	$14.08	71	$9,349.12
October	$1,000	$14.93	67	$10,913.83
November	$1,000	$16.95	59	$13,390.05
December	$1,000	$16.13	62	$13,742.76
Year-end Total	$12,000	$16.39	852	$13,964.28

The price per unit of the stock fluctuates as the market fluctuates. The example reflects that when the price goes up, you are purchasing fewer shares, but when the price is down, you can purchase more shares. Over the course of the year, you would realize an average cost of $14.36 per share, which would allow you to purchase an additional 48 shares and earn $786.72 more than if you had not used the method of dollar cost averaging.

Advantages

As an investment strategy, dollar cost averaging will provide you with a number of advantages. Perhaps the biggest advantage is that it greatly reduces the risk of losing money on your investment due to bad timing of stock purchases. By using this approach, you eliminate the need to decide when to invest, and this helps you avoid the temptation of trying to time the market, known as the buy low, sell high strategy. Dollar cost averaging encourages discipline in your program. For this method to work, you must purchase a specific dollar amount every month. Although the price of your investment may drop over the course of one year, if you continue to invest, you will eventually realize the lower average cost. The price should eventually regain and pass what it was before, and this will allow you to sell a larger number of shares at a higher price. Dollar cost averaging does, over time, smooth out market fluctuations.

Disadvantages

Dollar cost averaging is not necessarily the best choice if you have a large sum of money, a short amount of time, and your goal is to maximize the return on your investment. Richard Williams and Peter Bacon published an article in 1993 called Lump Sum Beats Dollar-Cost Averaging. In the past few years, financial experts have argued that dollar cost averaging is not as good as everyone thought it was. For contrary views about dollar cost averaging, see the *USA Today* article Dollar Cost Averaging's Not All It's Cracked Up To Be and the *Journal of Financial Planning* article Mathematical Illusion: Why Dollar Cost Averaging Does Not Work.

There are other strategies that are now recommended, one of them being value averaging. When one practices dollar value averaging, the goal is to make the value of your investment grow a certain constant amount every month. For more information on value averaging, read the article Value Averaging for 401(k) Plans Makes More "Cents" than Dollar-Cost Averaging.

Planning for Retirement

Having enough money to be comfortable when you retire should be one of the long-term goals of your financial planning. A 401(k) plan will offer you an excellent way to implement dollar cost averaging. In this type of investment, money is deducted and placed into your investment plan each pay period. Over time, you will realize the average lower per-share costs of dollar cost averaging. Another strategy you can use to build your retirement nest egg is through the reinvestment of dividends and capital gains. This is also a form of dollar cost averaging and one of the smartest things investors can do, as reinvesting usually costs you nothing in additional fees. You must remember that these plans are like all other forms of dollar cost averaging that, for them to be successful, you must continue to systematically purchase securities.

If you are investing small amounts of money over long periods of time, dollar cost averaging will serve you well. If your goal is to lessen the risk associated with the inevitable rises and falls of the stock market, then dollar cost averaging is a good choice.

If you choose to use this as your investment tool, you must remember that it neither guarantees profits nor eliminates losses. It does, however, provide a method of investing that will reduce anxiety over movements in the investment markets. Dollar cost averaging will only work if you continue to purchase systematically, regardless of market fluctuations. In turn, if you want to reap the rewards of this plan, you must stick with the program.

For an informal discussion of dollar cost averaging, read the JREF Forum topic Dollar Cost Averaging a bad investment strategy? For more information on investing, read the related articles in our Knowledge Center Library.

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