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WHAT IS DOLLAR-COST AVERAGING?

You can smooth out portfolio returns by investing consistently, whether the market is up or down.

By: Kate Stalter - May 18, 2023

When I work with clients who are still in their working years, I encourage them to continue investing through thick and thin, in every market cycle. That's a pretty easy process for those who can schedule automatic paycheck withdrawals into an employer-sponsored account, such as a 401(k).

That's known as dollar-cost averaging. It's a straightforward investment strategy whereby an account owner consistently invests a fixed amount of money at regular intervals, regardless of the current market conditions.

Here's what you need to know about dollar-cost averaging and why many investors choose it as a strategy to meet their long-term goals:

- Dollar-cost averaging smooths out returns over time.
- Investing a lump sum vs. dollar-cost averaging.
- Dollar-cost averaging spreads out the risk.
- Drawbacks to dollar-cost averaging.
- Stick to the plan.

Dollar-Cost Averaging Smooths Out Returns Over Time
The idea behind dollar-cost averaging is to reduce the impact of short-term market volatility on your investment by buying more shares when prices are low and fewer shares when prices are high.

For example, say you invest $100 monthly in a particular exchange-traded fund, or ETF. If the ETF's price is high, your $100 will buy fewer shares, but when the price declines, your $100 will buy more shares.

Over time, this approach aims to smooth out the ups and downs of the market and potentially reduce the risk associated with trying to time the market. By consistently investing over the long term, dollar-cost averaging allows you to build a diversified portfolio while minimizing the potential effects of market fluctuations on your investment.

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Jason Werner, an accredited investment fiduciary and founder of Werner Financial in Indianapolis, says his firm encourages dollar-cost averaging, especially when developing a long-term plan with investors who are able to commit a specific amount over a specific time period.

"The more frequent the contributions are for that investor, the more we can focus on dollar-cost averaging," he says. "Although we all would love to ideally implement our savings into our investment plans on the most opportunistic day or time, dollar-cost averaging provides a strong probability of acquiring our positions at the best price per share over the long term."

Werner is alluding to the time value of money, a concept that simply states a dollar today is more valuable than a dollar at some point in the future. It acknowledges that investing a sum of money today is generally more valuable than investing the same amount in the future due to factors such as inflation, earnings potential and opportunity cost. In that sense, lump-sum investing is preferable to dollar-cost averaging, but that's not always practical, and isn't even possible with an employer-sponsored 401(k) or similar account.

Fortunately, dollar-cost averaging is also a strategy that pays off over time.

"A level amount invested monthly over the past 20 years in the S&P 500 would have resulted in more than triple your principal amount if you also reinvested the dividends," says Ryan Johnson, managing director of investments at Ohio-based Buckingham Advisors. "The principal plus growth would have turned every $1,000 into more than $3,000."

Investing a Lump Sum vs. Dollar-Cost Averaging

Kendall Meade, a financial planner with San Francisco-based SoFi, says investors with a lump sum of cash are better off investing it all at once. However, she notes, risk-averse investors may feel more comfortable using dollar-cost averaging.

"For most people, I recommend lump-sum investing large amounts of money you have available and using dollar-cost averaging to invest on an ongoing basis," she says.

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Mark Henry, founder and CEO of Alloy Wealth Management in Greenville, South Carolina, encourages clients to dollar-cost average during their working years. "It's a great way to supercharge compound interest," he says, adding that dollar-cost averaging is helpful for both long-time investors and those who are just getting started, but may not have much to invest.

"Putting small amounts of money into the market on a regular basis gives you a chance to still benefit from market growth without having to constantly worry about price volatility. Plus, it creates the healthy habit of investing regularly to build wealth over time," Henry says.

Dollar-Cost Averaging Spreads Out the Risk

I agree with that approach, and it's one I've used in my advisory businesses. Most of the time, my clients are comfortable with the concept, but it's not unusual to find investors who are nervous about buying when stocks are either high or low. In the former case, they worry that a pullback will occur soon after they invest. In the latter situation, some aren't comfortable investing when the market has been in a downtrend.

Clark Kendall, president and CEO of Kendall Capital in Rockville, Maryland, addresses those concerns. Dollar-cost averaging, he says, is most effective with securities that fluctuate in value and go up over the long term.

"For example: putting $100 a month into a mutual fund or stock that fluctuates between $10 and $20 allows the investor twice as many shares at $10," he says. "After a year, [let's say] the investor has paid $1,200 for 90 shares with an average cost of $13.33. So even if the mutual fund ends the year at $15, the investor is up 12.5%."

"When market valuations are clearly high, you can occasionally add alpha by delaying contributions." - Brian Huckstep, chief investment officer at Advyzon Investment Management

Michael Collins is founder and CEO at Massachusetts-based WinCap Financial. He describes a client who was uncomfortable investing a large lump sum in the market, concerned about the potential risks.

"After discussing the concept of dollar-cost averaging, they decided to allocate a portion of their total capital over the course of a few months," Collins says. "This allowed them to spread out their risk and to benefit from market movements in multiple directions. Their overall returns were higher than if they had invested their entire capital into the market all at once."

Not all advisors routinely advocate dollar-cost investing.

Brian Huckstep, chief investment officer at Advyzon Investment Management in Chicago, doesn't encourage clients to use dollar-cost averaging, but says he recognizes two situations where it can make sense.

"When market valuations are clearly high, you can occasionally add alpha by delaying contributions," he says, referring to a method known as tactical investing.

Huckstep says a second situation occurs when an investor is nervous about the markets.

"There are dozens of reasons that investors can be jumpy. Previous losses scared the investor, a convincing talking head on a television business network says the market is on the precipice of catastrophe, or too much spicy food for lunch," he jokes.

Read the entire article here: https://money.usnews.com/investing/investing-101/articles/what-is-dollar-cost-averaging