

The Retirement Strategist

Dollar Cost Averaging

An alternative to lump-sum investing, dollar cost averaging is a popular technique for investing a fixed dollar amount in a security at regular intervals (generally, monthly or quarterly). By investing continuously and systematically, this strategy takes advantage of market fluctuations over time to reduce the average share price you pay for the security. Although the strategy can't protect you from loss in a declining market or guarantee that your investment will gain, it does eliminate the need to decide when to invest, thus requiring no effort to "time" the market. To reap the full benefits of dollar cost averaging, however, it's important to continue investing even through periods of market decline. For this reason, dollar cost averaging becomes most effective when coupled with long-term investment goals, such as saving for your retirement in an IRA or a 401(k).

How does it work?

To be effective, dollar cost averaging requires you to invest the same amount of money in a particular security (e.g., a stock or

a mutual fund) on a regular basis. By doing so, your money will automatically buy more shares when the share price of the security is low and fewer shares when the price is high, thus generally decreasing your average price per share.

Table A illustrates how share price fluctuations can yield a lower average cost per share when you invest the same dollar amount regularly.

In this example, the average market price per share over the five-month purchasing period is \$20 per share ($\$25 + \$20 + \$10 + \$20 + \$25 = \100 , divided by 5 = \$20). However, because the regular amount of the monthly investment buys more shares at the lower share prices, the average purchase price per share is \$17.85 ($\$1,000$ invested divided by 56 shares purchased = \$17.85). Note: This example is for illustrative purposes only, and does not represent any particular investment.

TABLE A

| Regular Investment | Price Per Share | Shares Purchased |
|--------------------|--------------------------------|------------------|
| \$200 (each month) | \$25 | 8 |
| \$200 | \$20 | 10 |
| \$200 | \$10 | 20 |
| \$200 | \$20 | 10 |
| \$200 | \$25 | 8 |
| \$1,000 Total | Average Price Per Share = \$20 | 56 Total Shares |

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As this example illustrates, the average cost per share will always be lower for the period of time during which you're investing than the average market price per share for that same time period. This will hold true whether the market is rising, falling, or fluctuating.

Dollar cost averaging vs. lump-sum investing

Every investor wants, in the words of the market adage, to "buy low and sell high." Lump-sum investors (ones who purchase an investment all at once or over a short period of time, usually a matter of a few weeks) try to time their security purchases and sales in an effort to do just that. When successful, they may realize greater profits in a rising market than investors following a dollar-cost averaging strategy, as Table B below illustrates.

TABLE B

| Regular Investment | Price Per Share | Shares Purchased |
|--------------------|-----------------------------------|-----------------------|
| \$200 (each month) | \$12 | 16.67 |
| \$200 | \$14 | 14.28 |
| \$200 | \$16 | 12.5 |
| \$200 | \$18 | 11.11 |
| \$200 | \$20 | 10 |
| \$1,000 Total | Average Price Per Share = \$16 | 64.56 Total Shares |

At the end of the five-month investment period, the dollar cost averaging investor's position has a total value of \$1,291.20 (64.56 shares multiplied by the \$20 final share price), and has realized a gain of \$291.20. However, a lump-sum investor making an investment of \$1,000 in the first month would have bought 83.33 shares at a purchase price of \$12 per share. Had that investor held those shares for five months until the share

price reached \$20 per share, the total value of his or her position would then be \$1,666.60 (83.33 shares x \$20 per share), for a gain of \$666.60. While both investors have realized a gain, the lump-sum investor's position has outperformed that of the dollar cost averaging investor. Note: This example is for illustrative purposes only, and does not represent any particular investment.

The problem for any investor, but particularly a lump-sum investor, is always that of knowing when to buy and when to sell, of properly timing his or her investment decisions. The market is not entirely predictable; if a lump-sum investor buys high and sells low, he or she will suffer a loss. While a dollar cost averaging investor might also suffer a loss in a declining market, the loss may be less severe than that of his or her lump-sum investor counterpart, as indicated in Table C on the next page.

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TABLE C

| Regular Investment | Price Per Share | Shares Purchased |
|--------------------|-----------------------------------|-----------------------|
| \$200 (each month) | \$16 | 12.5 |
| \$200 | \$14 | 14.28 |
| \$200 | \$12 | 16.67 |
| \$200 | \$10 | 20 |
| \$200 | \$8 | 25 |
| \$1,000 Total | Average Price Per Share = \$16 | 88.45 Total Shares |

In this instance, the dollar cost averaging investor's position at the end of the five-month investment period has a total value of \$707.60 (88.45 shares x \$8 per share), for a loss of \$292.40. But consider the lump-sum investor who bought at a price of \$16 per share. His or her \$1,000 investment bought 62.5 shares; five months later, those shares are worth \$500--for a loss of \$500. Note: This example is for illustrative purposes only, and does not represent any particular investment.

Because a dollar cost averaging investment strategy buys more shares of a security as the price of the security declines, this strategy does offer some downside protection in a declining market. What's more, as the market rebounds, a dollar cost averaging investor will "break even" (or realize a gain) more quickly than his or her lump-sum investor counterpart. That's because the dollar cost averaging investor owns more shares (at a lower cost per share) than does the lump-sum investor.

In the last example above, the dollar cost averaging investor's cost per share is \$11.31 (\$1,000 divided by 88.45 shares), while the lump-sum investor's share cost is \$16 per share. Thus, should the dollar cost averaging investor need to sell, he or she would at least break even on his or her initial investment

at a share price lower than the share price needed by the lump sum investor. In addition, the dollar cost averaging investor will realize a profit sooner if the stock price increases. If the share price rises to \$12, the dollar cost averaging investor's 88.45 shares would be worth \$1,061.40 (a gain of \$61.40), while the lump-sum investor's 62.5 shares would be worth only \$750--a net loss of \$250. Note: This example is for illustrative purposes only, and does not represent any particular investment.