FAQs - Starting a New Career & Early to Mid Career

What is Dollar Cost Averaging?

One of best approaches we can use to reduce investment risk is to deploy a strategy known as Dollar Cost Averaging (DCA).

Know it or not, you may already be doing this if you contribute to an IRA, 403B, or 401K plan on a regular basis. And that's a good thing because dollar cost averaging works. Here's why.

In broad terms, the stock market goes up in value seven out of every ten years. History tells us that in any one year, the probability of the market going up is 70%. If we look at each five year period, the success rate goes up to 90%. So, how can we lose in stock market investing?

Of course, the problem is that the market does not always go up. In fact, in most years, there will also be a time when the market drops 10-20% from the highest point during that year. Even though from January 1 through December 31, the market rises about seven in ten years, the market will likely drop at least 10% from its high point during the year. Increasingly, we find that the drop is becoming more closely centered on a 15% drop from the top.

There is much volatility day-to-day and month-to-month. That's why people don't think the market is a safe place to invest. One day it's up, the next day it's down, and sometimes it's down a lot! The fluctuations make potential investors nervous, often paralyzing them to stop making more investments, or to stop altogether.

A scary day in October 1987 comes to mind – the market dropped 22% in one day. Panic was everywhere! Yet, had you been in the Peace Corps that year or recovering from back surgery or involved in some other activity that caused you to miss the news of that fateful day, you would have found that the market was actually up that year. From January 1 to December 31, the overall market was a winner, even with that tumultuous, scary, disastrous – but ultimately inconsequential – day.

It always seems that the drops are more dramatic than the rises because losses make headlines and gains do not. The temporary drops in the market make it on the nightly news, but the real news is that the trend of the equity market is and always has been up. Of course, that October day in 1987 was only inconsequential to those who did not panic. For those who did panic and sold out of their investments, the fact that the year was a net positive was of little consequence to them. They guaranteed their own ruin by failing to abide by the knowledge that all drops in the market, however horrific on the surface, are all temporary. So, if things are so volatile and uncertain, what is a relatively conservative investor to do? The answer may be Dollar Cost Averaging.

When you really think about it, this concept is not all that remarkable because you use it all the time.

When you go to the grocery store expecting to buy two cans of tuna for $2.99 each, and you arrive to find that the price of tuna is 99 cents per can because of a "manager's special", what do you do? You load up, right?

In every aspect of our economic life, we have learned that when the price is down, we should buy more. Buy-one-get-one-free promotions are very successful because they grab our attention. It's a great deal in many cases. But why then do we not act the same way when stock market prices are low?

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What is it about human nature that says buy tuna fish, buy an extra pair of shoes, buy four tires instead of the two you really need when the prices are down.

But that same human nature says "not only should I not buy more shares when the price is down, I want to sell all the shares I currently have at this depressed price?" You and I both know what it is. The simple human reaction to falling stock prices is the fear that things will continue to go down. And down. And down some more until it is zero.

Of course, as we have already discussed, the great companies of America and the world will not go to zero. They will simply go "on sale" from time to time, just like the tuna fish. But where will you be when that happens? Will you be in the buyers' line or the sellers' line?

The use of DCA forces you – against your human instinct – to do exactly the right thing. By investing the same amount of money every month (or week or year), you force yourself to buy more shares when the shares are cheap and to buy fewer shares when the price is high. It forces you to do exactly what you would do in every other part of your purchasing life.

The people who benefited the most from the bull markets of the 1990's and 2010's were not the people who got in and made their first investments in the 1990's or the 2010's. Instead, it was the people who continued to slowly and inexorably amass shares throughout the 1970's and 80's using a dollar cost averaging strategy. Or the folks who started adding money to their investment accounts right after Dot Com bubble burst in early 2000's. Despite the ups and downs of the 1970's and 2000's (mostly downs), the people who had faith that their continued purchase of relatively cheap shares would pay off were more than well rewarded by the booms that later followed.

Dollar cost averaging involves continuous investment in securities regardless of fluctuation in price levels of such securities. An investor should consider their ability to continue purchasing through fluctuating price levels. Such a plan does not assure a profit and does not protect against loss in declining markets.