



Ruminations on Dollar Cost Averaging

Dollar Cost Averaging (hereafter DCA) is the technique of periodically investing a fixed dollar amount to reduce risk. Proponents claim this “drastically reduces market risk” by purchasing fewer shares when prices are high and more shares when prices are low. Financial research has shown, however, that DCA does not perform better than investing randomly.

What most people call DCA is more accurately called investing as soon as you have money. In other words, they are systematically investing in their 401(k) or other retirement vehicle as they get paid each month. Investing as soon as you have funds is a prudent strategy.

However, if you have a lump sum to invest, entering the market slowly will decrease risk simply because the funds aren't invested. Cash is less risky than stocks, but also earns less. Investing immediately in the appropriate asset allocation is the mathematically correct decision.

If DCA worked, as soon as you were fully invested you should immediately withdraw the funds to begin the strategy anew. Obviously, that makes no sense.

Notwithstanding the previous paragraph, from a psychological perspective, investing a large lump sum all at once may lead to strong feelings of regret if the market subsequently declines. Since research shows we feel the pain of losses about twice as strongly as the pleasure of an equal-sized gain, mitigating those feelings may be prudent. Make no mistake though; the strategy is sub-optimal for wealth accumulation.

Notes:

The analysis in this report has been prepared by David E. Hultstrom, MBA, CFP[®], CFA[®].

Mr. Hultstrom is the president of Financial Architects, LLC, a financial planning and wealth management firm. Questions or comments are welcome, and he may be reached at David@FinancialArchitectsLLC.com or (770) 517-8160.



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