



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. He may be reached at (770) 517-8160 or David@FinancialArchitectsLLC.com.

Reasonable care has been taken to assure the accuracy of the data contained herein and comments are objectively stated and are based on facts gathered in good faith. We disclaim responsibility, financial or otherwise, for the accuracy or completeness of this report. Opinions expressed in these reports may change without prior notice and we are under no obligation to update the information to reflect changes after the publication date. Nothing contained in this material is intended to constitute legal, tax, securities, or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax, and investment advice from a licensed professional. Past performance is no guarantee of future results. This is not an offer, solicitation, or recommendation to purchase any security or the services of any organization. Forecasting represents predictions of market prices and/or volume patterns utilizing varying analytical data. It is not representative of a projection of the stock market, or of any specific investment. The foregoing represents the thoughts and opinions of Financial Architects, LLC, a registered investment advisor. Your mileage may vary.

This report was originally written in August, 2008, and was last reviewed/updated in January, 2010.

© Financial Architects, LLC