Dollar Cost Averaging: When Should I Invest This Money?

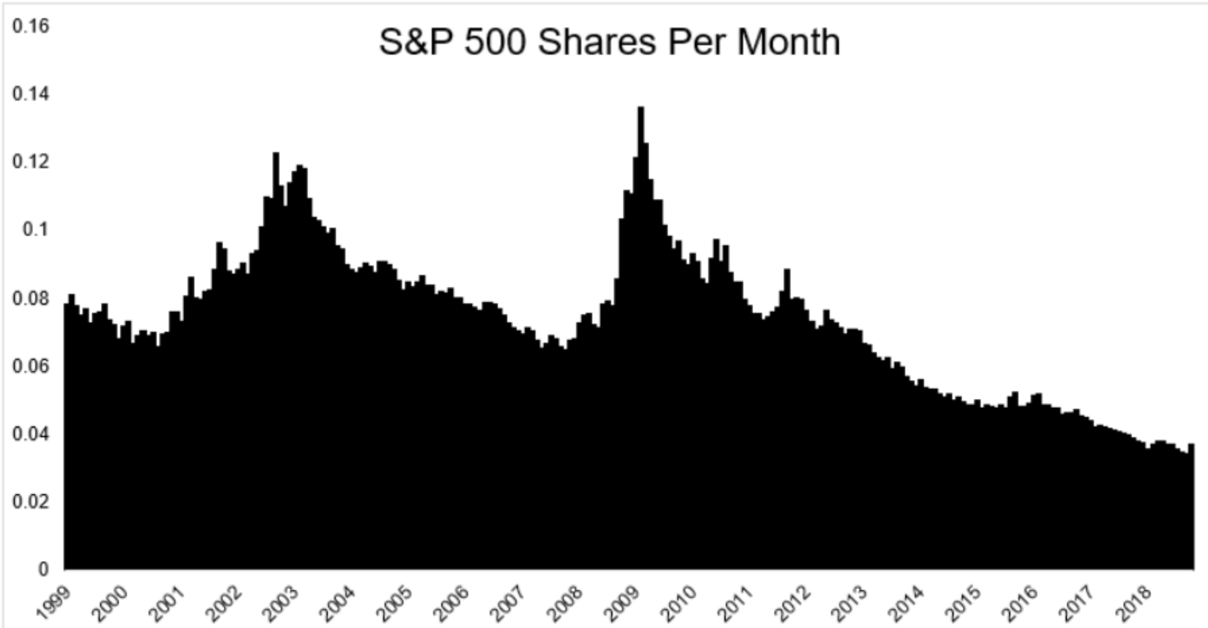
Most people think of market timing as trying to decide when to get out of the market in order to avoid the next downturn. However, market timing works the other way too. Sometimes investors have a lump sum to invest and they're trying to determine a good entry point. I have seen several examples of this among my clients over the past month. In one case, a client is adding $300k from savings to their portfolio and was debating when to pull the trigger. In another case, a client has been out of the market for the last two weeks as his profit sharing plan is being rolled over to an IRA. He missed last week's market rally and now he is asking if he should wait for the next dip to get back in. The third scenario is a client who is trying to figure out the best time to reduce her exposure in a concentrated stock position and add it to her diversified portfolio.

The sad and unsatisfying truth is that even the most seasoned investment professionals cannot tell you (with any degree of certainty) what the market will do in the next week, month, or year. So, what should these people do?

One option is dollar cost averaging. This means that you invest a set dollar amount in equal installments over time. The classic example of dollar cost averaging is 401k contributions. Suppose a worker contributes $100 from each paycheck to their 401k. The $100 contribution buys 10% more shares after stock prices decline by 10% and 10% fewer shares after stocks rise by 10%.

Systematic contributions into a 401k ensure that you continue to invest during and after market downturns. The objective of all investors is to buy low and sell high. However, this is incredibly hard to do. Normal human emotion (and intuition) will tell you to buy when things are going up, and get more conservative, "wait and see", during and after market declines. So, in theory, dollar cost averaging should make you a better investor by eliminating the temptation to try to time the market and causes you to keep buying stocks during and after market declines (when stocks are cheaper).

I borrowed this chart and some stats from an article by Michael Batnick at [the Irrelevant Investor](). The chart below shows the number of shares of you would purchase with a systematic $100 monthly investment in the S&P 500 index. You can see that the number of shares purchased increased during big market downturns (2000-2002) and (2007-2009) with the same $100 investment.



Does Dollar Cost Averaging Improve Investment Returns?

Dollar cost averaging works really well… some of the time. Looking at the past 20 years (1999-2018), a lump sum invested in the S&P 500 would have averaged only 5.6%. This was not a great 20-year period for the S&P. However, if you made systematic contributions every month over the past 20 years, your average annualized rate of return would have been 7.9%. This is because the first 10 years were not very good, but half of the contributions occurred in the last 10 years after the last major downturn.

If it seems like dollar cost averaging worked well in this example, it did. But before you get too excited about it, consider that the average rate of return would have only been 4% if the sequence of returns were reversed. In that case, a lump sum investment in the beginning would have produced the better result.

Referring to the three clients from the first paragraph, any of the 3 options have the potential of producing the best result by choosing to either invest all money now, wait until a hopefully better time, or contribute systematically over a time (starting now). The option I like the least is waiting for a better time. Waiting to invest until stocks are cheaper is the decision that could lead to the most regret and cause the investor the most stress as he or she constantly agonizes over "when" to pull the trigger.

I would be more likely to dollar cost average into the market in periods when stocks are expensive or volatility is unusually high. I would be inclined to invest the lump sum in periods of reasonable valuations and/or low volatility. Either of those two decisions may end up working out better than the other, but you will only know in hindsight. So make a decision, and don't look back.

It is time to get on with making memories and checking items off your bucket list.

Have a great week.

THOUGHT THAT WAS INTERESTING

Does Insurance Cover That?

I must admit, my understanding of homeowner's insurance is a bit rusty. I saw this homeowner's insurance quiz in Kiplinger's and thought I would get at least 8 out of 10 correct. Uhh…let's just say, I overestimated myself. Almost every homeowner buys insurance, but then doesn't really know what is covered. Check out the 10 scenarios posed by this quiz and see how you do. Hopefully better than me. If you get less than 6 out of 10 correct, we can still be friends. 😊

TAKE THE QUIZ