



## Common Questions Regarding Dollar Cost Averaging

*Despite strong academic evidence against dollar cost averaging (DCA), investors are often unsure whether they should invest a lump sum of money all at once or spread it out over time. Similarly, investors who may have gotten out of the market may be trying to decide if they should get back in all at once or in intervals. The following answers some common questions regarding DCA.*

Instead of investing assets in a lump sum, dollar cost averaging (DCA) is a timing strategy that periodically invests a fixed amount of money in a particular investment or portfolio over a given time interval. The purpose is to lower the total average cost *per share* of the investment, giving the investor a lower overall cost for the shares purchased over time.

### **Is there any advantage to using DCA as an investment strategy?**

From an academic perspective, the answer has long been “No.” The June 1979 issue of the *Journal of Financial and Quantitative Analysis* published an article by University of Chicago professor George Constantinides titled “A Note on the Suboptimality of Dollar-Cost Averaging as an Investment Policy,” which demonstrated that DCA is an inferior strategy to lump-sum investing.<sup>i</sup> This was followed by a 1992 paper published in the *Financial Services Review* by professors John Knight and Lewis Mandell titled “Nobody Gains From Dollar Cost Averaging: Analytical, Numerical and Empirical Results.” In the paper, the authors conclude,

“Using three separate methods of comparison, we have shown the lack of any advantage of DCA relative to two alternative investment strategies. Our numerical trial and empirical evidence, in consonance with our graphical analysis, both favor optimal rebalancing and buy and hold strategies over dollar cost averaging.”<sup>ii</sup>

Another way to think about DCA is this: Assume that staying fully invested in equities is suboptimal, which means investors should sell all their equities and then get back into the market through DCA. At the next investment period, investors following DCA would have some money in the stock market already. While they had planned to periodically reinvest in the market, they have also determined that staying fully invested is suboptimal. This presents a logical difficulty. Do they continue to buy equities, sell their existing holdings or do both? This demonstrates why DCA cannot logically be effective.

### **Why does DCA seem to be so popular?**

Unfortunately, investors and advisors still recommend DCA despite the academic evidence. They argue that since markets are volatile, DCA allows investors to avoid investing too much when the market is priced high and investing too little when the market is priced low, thus reducing overall market risk. However, they ignore the simple logic that since there is always an equity risk premium (as stocks have higher expected returns than bonds), common sense tells us to invest all at once. Unfortunately, investors and advisors do not always base decisions on logic or evidence. In fact, emotions (such as fear) often play a far greater role in decision-making than logic.

## When does DCA make sense?

While DCA is not an optimal investment strategy, there is an argument to be made in its favor when it is the lesser of two evils: when an investor simply cannot “take the plunge” and invest all at once for fear of what could happen in the market. That fear causes paralysis. On one hand, investors are loathe to buy at even higher prices should the market rise. On the other hand, they may be scared to invest if market prices are falling because the bear market they feared has now arrived. Once a decision has been made to not buy, how do they decide to buy?

One solution to this dilemma is to write down a plan for a lump-sum investment. The plan should lay out a schedule with regularly planned investments. The plan might look something like one of these alternatives:

- s Invest one-third of the investment immediately and invest the remainder at a time during the next two months or next two quarters.
- s Invest one-quarter today and invest the remainder spread equally over the next three quarters.
- s Invest one-sixth each month for six months or every other month.

Once the plan is written, the investor should instruct the advisor to implement the plan, regardless of how the market performs. Otherwise, the latest headlines or guru forecasts might tempt the investor.

If the market rises after the initial investment, the investor can feel good about how the portfolio has performed and the decision to not delay investing. On the other hand, if the market falls, the investor can feel good about the opportunity to now buy at lower prices and being smart enough not to have jumped in all at once. Either way, the investor wins from a psychological perspective. Since emotions play an important role in how individuals view outcomes, this is an important consideration.

Once an investor is convinced that a gradualist approach is the correct one, it is important to ask the following question. “Having made your initial partial investment, do you now want to see the market rise or fall?” The logical answer is that one should root for the market to fall so that one gets to make future investments at lower prices.

## Sources

The following sources were used by the author(s) to arrive at the above conclusions. You may wish to reference these sources to help you prepare to use the ideas presented in these talking points with prospects and clients.

- <sup>1</sup> George M. Constantinides. **A Note on the Suboptimality of Dollar-Cost Averaging as an Investment Policy.** *Journal of Financial and Quantitative Analysis*, Volume 14, Issue 2. June 1979. Available at [http://faculty.chicagobooth.edu/george.constantinides/documents/JFQA\\_1979.pdf](http://faculty.chicagobooth.edu/george.constantinides/documents/JFQA_1979.pdf)
- <sup>2</sup> **Knight and Lewis reference.** Available at <http://www.financial-spread-betting.com/Dollar-cost-averaging.html>. Accessed June 23, 2009.

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