Why Dollar-Cost Averaging is a Good Idea

At times such as these when more than a few reasonably experienced Wall Streeters have commented on the richness of current stock valuations, it makes sense to review worthwhile investment approaches that have been tested over time. One that tends to get a lot of lip service, though certainly less attention in practice, is Dollar-Cost Averaging. With that strategy, the investor commits to buy a fixed dollar amount at regular time intervals, which might be monthly, quarterly or some other period.

One of the key arguments in favor of Dollar-Cost Averaging is the benefit of gaining an average cost over time, rather than committing all at once and risking the possibility of being on the cusp of a significant market downturn. For most investors, this benefit may sound more promising than it really is. Why? Because the market moves up two-thirds of the time, the probability is that the average prices paid will be higher than they might have been from a one-time investment.

The Main Benefit is Psychological

So if we accept the fact that the odds are not in your favor, why bother moving ahead in this fashion? The best reason I can think of is that it bolsters investors' confidence in the implementation of their plans.

Understanding the importance of psychology in the investment process, it's essential to provide an adequate foundation of sensibility when getting under way. Although most of us don't want to talk about it, there's always the nagging thought that something you just bought will go down and whatever you just sold might start going up. When this sense is extrapolated to a series of commitments, it takes on an even greater dimension.

On those occasions when this fear is followed by an unpleasant reality, it leaves an emotional blemish that may linger. It's well known that psychology plays a critical role in short-term market movements, so new commitments that begin on this note have a habit of resonating later on during periodic market corrections and reinforcing thoughts of bailing out at the wrong time.

It's well known that investors are their own worst enemies, which suggests that efforts to limit damages from irrational decision-making are well worth pursuing. The Dalbar study of investor behavior underscores this truth. Over the latest 30 years, investors in equity mutual funds had returns that were 60% worse than those of the Standard & Poor's 500. They bought when the averages were high and ran for the exits when the market hit air pockets. Exactly the opposite of what should have happened.

The process of averaging in over a period of time builds essential psychological support into the equation. Rather than worrying about price movements after adding positions, the investor looks forward to changes with the assurance that his process will smooth the fluctuations and provide him with an average of the prices prevailing over the period. Thus, price changes are anticipated and managed, rather than feared.

It Works Both Ways

The same is true for the selling part of the investment process. In addition to the importance of timing sales to reduce tax liability (unless there's a compelling reason to sell all at once), the psychological benefit is equally true when reducing or eliminating holdings. I suspect this is even more so with holdings that have increased substantially in value.

On one hand, there's concern about capturing gains that are already in place. But on the other hand, one has to wonder whether the investment is one of those rare birds such as Google or Apple that seems to have no upside limit.

In both directions, a measured approach tends to feel a lot better.