Financial Planning

Dollar Cost Averaging:

Building Your Portfolio Over Time

In this age of information and technology, we are constantly reminded by the media of just how volatile the market is. Oftentimes market volatility will cause investors to make emotional decisions about their portfolios. As markets decline, some investors may panic and liquidate their portfolios. Conversely, as markets rise, investors may jump on the bandwagon and buy more investments in their portfolios. However, following emotions and trying to time the market can be an expensive investment strategy and often results in selling at low prices and buying at high prices, which is exactly the opposite of what a prudent investor would do.

One strategy that may help to reduce the risk of market timing errors when investing in the market is dollar cost averaging. Dollar cost averaging is a systematic, disciplined approach to investing and may help you to avoid costly emotional decisions about when is the best time to invest.

Keep in mind, however, that dollar cost averaging does not guarantee profit or protect against loss in declining markets. Before committing to a dollar cost averaging program, it's important to consider your ability to tolerate market fluctuations from both an emotional and a financial perspective.

How it Works

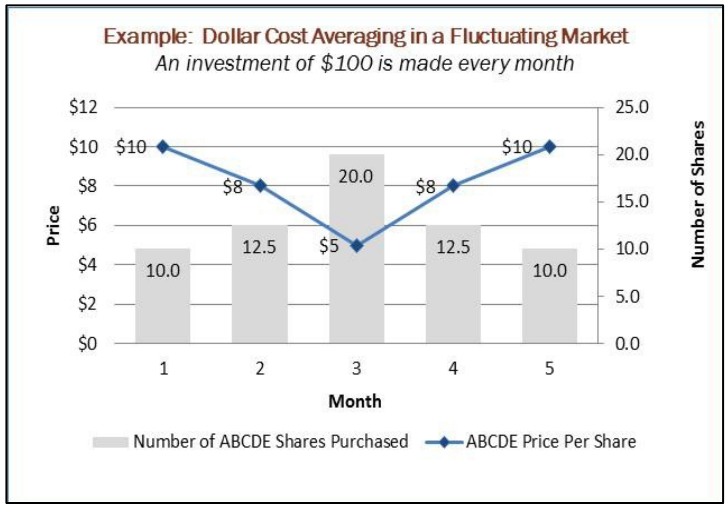
Dollar cost averaging requires that you invest the same dollar amount in the same investment at regular time intervals, regardless of the market price of that investment. Doing so will allow you to take advantage of market fluctuations by buying more shares when the price is lower and less shares when the price is higher. In addition, the average cost per share of your investment will be lower than the average price per share of that investment for that same period.

You can begin a dollar cost averaging program with small amounts, sometimes as little as $50, depending on what investment you choose to buy. You can purchase the investment monthly or quarterly. Committing to a dollar cost averaging program will allow you to accumulate assets on a regular basis, making the process convenient and efficient.

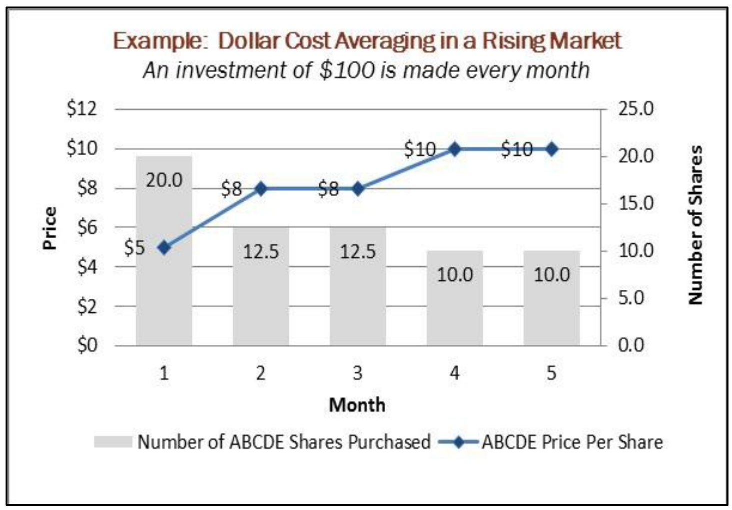
Let's look at an example of how dollar cost averaging works. Assume you determine that you have an extra $100 a month that you can invest and that you'd like to buy shares of ABCDE with those funds. The price of ABCDE moves up and down with the market over time. When the price is lower, that $100 will buy more shares. When it's higher, you'll buy fewer shares. This is true regardless of the market movement.

The following charts illustrate these purchases over a fluctuating market, rising market and falling market. Note that in all three cases, the average cost per share after five months is lower than the average price per share for the same five months.

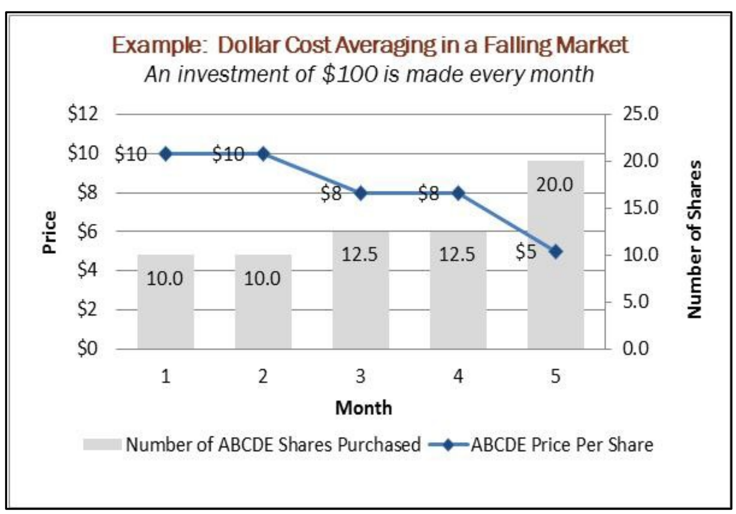
Average cost per share:
$7.69 ($500 ÷ 65 (10+12.5+20+12.5+10+10))
Average price per share:
$8.20 ((10+8+5+8+10) ÷ 5)



Average cost per share:
$7.69 ($500 ÷ 65 (20+12.5+12.5+10+10))
Average price per share:
$8.20 ((5+8+8+10+10) ÷ 5)



Average cost per share:
$7.69 ($500 ÷ 65 (10+10+12.5+12.5+20))
Average price per share:
$8.20 ((10+10+8+8+5) ÷ 5)



When to Use Dollar Cost Averaging

The example above illustrates the dollar cost averaging strategy in a nonqualified (taxable) account. However, the strategy can also be implemented in qualified retirement accounts. In fact, most people use dollar cost averaging when they participate in their employer-sponsored retirement plan, such as a 401(k) plan. They commit to invest a set dollar amount from every paycheck in a certain mutual fund or funds. This “pay yourself first” strategy can help you to accumulate assets consistently over time.

At Benjamin F. Edward & Company, there are several options that enable you to take advantage of the dollar cost averaging strategy. Our systematic investment program allows you to purchase shares of a mutual fund over regular intervals such as monthly or quarterly. In addition, our free dividend reinvestment program allows you to automatically reinvest dividends you receive to purchase additional shares, thus compounding earnings and accumulating assets. Remember that you will be required to pay tax on the dividend income earned each year (even if it is reinvested).

Another way to use dollar cost averaging is when you have a lump sum to invest. While opinions vary on the effectiveness of investing a lump sum over time, many experts feel that it is a good way to take the guesswork out of trying to determine the proper time to invest a lump sum in a selected investment. By investing over time, you will attain the benefit of a lower average cost per share and may also reduce the stress associated with timing of a lump-sum investment.

Considerations

Dollar cost averaging is a systematic strategy for investing. It helps to take the guesswork out of investment timing and lets you focus on accumulating assets. It can also be an effective automatic investment strategy, which is particularly appealing for those who might find it challenging to save consistently over time.

Dollar cost averaging does not, however, guarantee profits or protect against losses in a fluctuating market environment. As with any investment strategy, you could lose money if the market declines after you’ve purchased the investment.

Because dollar cost averaging involves continuous investment in securities regardless of fluctuating market prices, it’s important that you consider your financial and emotional ability to continue your purchases through both rising and falling markets.

Dollar cost averaging is a long-term strategy that ignores day-to-day market fluctuations, which helps many investors to alleviate stress when it comes to the timing of investing in volatile markets. Talk with your financial advisor today about how these and other investing strategies may help you and your family achieve your saving and investing goals. ■