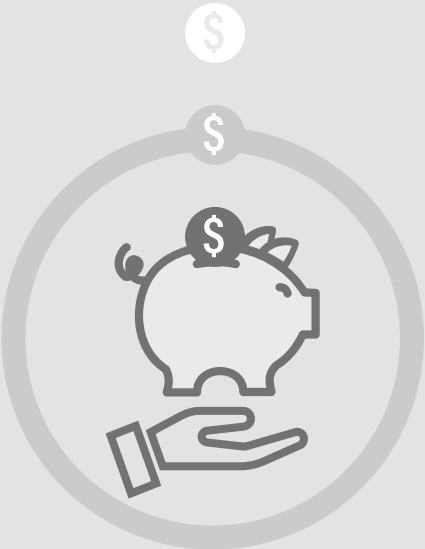
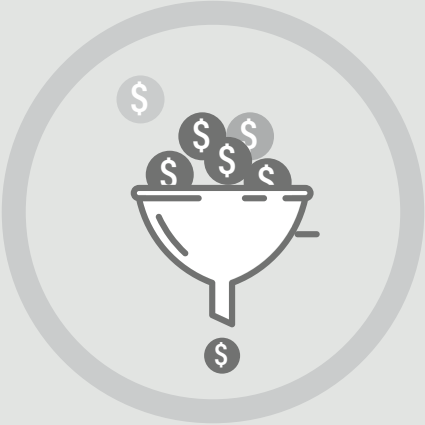
Dollar-Cost Averaging or Lump Sum Investing?



Dollar-cost averaging (DCA), is making regularly scheduled investments into an investment fund over a long period of time. For example, investing an equal amount on the 15th of every month. DCA has been an extremely controversial and hotly debated approach to investing. This applies both to practitioners and theoreticians, as well as internet discussion groups, which contain lively debates on the subject, with a fascinating mixture of beliefs, prejudices, opinions, facts and statistics. So, what are investors to believe and do? Read on to learn both sides of the argument.

INVESTMENT ESSENTIALS

PRACTICAL MATH



The Good Side: DCA Makes Cents

The idea of Dollar Cost Averaging (DCA) is intuitively appealing and makes a lot of sense. In a steadily rising or volatile market, investors buy in at a low average price over time. In a falling market, the same investments will purchase a larger number of units. All in all, regular investments have the potential to help investors manage the impact of market volatility.

Regular investing can be a good thing, and is the only way many people can invest, so the discipline pays off in that sense alone. Furthermore, DCA allows you to do the opposite of another very controversial element of investment-market timing. If an investor were considering investing a lump sum from an inheritance, for example, and the market looked overheated or precarious for any reason, it may be prudent to drip feed into stocks.

Also, a great advantage of DCA, says George Smyth of the MotleyFool.com ("Blind Dollar Cost Averaging," March 2000), is that the gentle moves into the stock market mean you "can place yourself at the proper comfort level." Precisely when Smyth wrote these words, a lump sum would have collided head on with the great dotcom bear market.

Even the otherwise skeptical Richard Williams and Peter Bacon, writing in the *Financial Planning Association Journal* ("Lump Sum Beats Dollar-Cost Averaging," June 2004), agree that DCA can reduce risk and potentially help avoid "investing all the money at a market high."

The Bad Side: No Guarantees

The potential advantages undoubtedly prevail up to a point, but many experts on both sides of the Atlantic warn against regarding the approach as a cure-all. They say that it by no means guarantees better returns than lump-sum investments. Furthermore, they stress that investors are not always protected effectively against volatile and falling markets.

After all, investors who started their regular payments in 2000 had a pretty bad time until 2003. They would have kicked off with a downhill run and the odds are they would eventually have bailed out in panic during the dotcom bear market. Some observers point out that in a long sideways or downwards market, DCA does not differ much from a buy-and-hold strategy. Even more skeptical commentators argue that at its worst, DCA is little more than a marketing trick to convince people to hand over money regularly, ensuring trading commissions.

> Regular investing can be a lot better than no investing at all. If the choice is between investing $50 a month or treating yourself to an extra night on the town, it is clear which option has the potential to help see you through your old age.

The Ugly Side: Risk/Return Controversy

What evidence is there on the returns from DCA? Williams and Bacon make their position very clear, saying: "Even without dividends, annuity investments into the S&P 500® and other indexes generally fall short of an investment up front." This statement is based on a methodologically sound long-term study over 65 years. Their historical findings are strongly in favor of investing a lump-sum immediately, provided, of course that you have a lump sum to invest.

Also writing in the *FPA Journal*, Robert Atra and Thomas Mann ("Dollar-Cost Averaging and Seasonality: Some International Evidence," July 2001), sum up what is surely the essence of the matter: "The results (of various studies) suggest that DCA is neither as effective as the personal finance literature claims, nor as sub-optimal as the academic literature claims." The popular investment press tends to claim that DCA reduces risk and enhances return. This would be wonderful, but the world of money is full of tradeoffs, and it would seem more likely to be one benefit or the other, rather than both. DCA has tended to reduce risk, but frequently at the expense of return.

Dollar-cost averaging is not an investment technique for all seasons. If you get the season right, you can win both ways, but, as we know, not only does winter inevitably arrive, but the summertime blues can intervene long before that.

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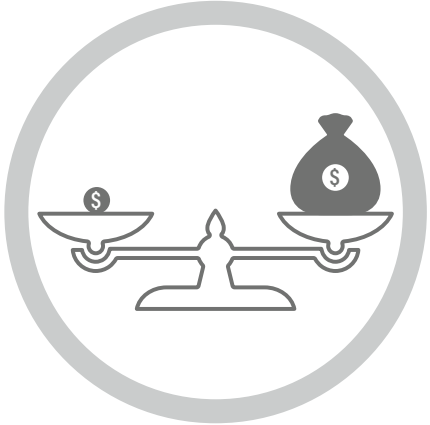

DCA vs. Lump-Sum Investing

Both lump-sum investing and DCA have their appropriate time and place. Research shows that lump-sum investing has paid off about 66% of the time, which is a long way from all the time. It certainly makes sense to look carefully at the current market conditions. If you hit that bad 33% in lumpy style, you can lose a lot of money.

On the other hand, many DCA users fail to monitor their investments after they start. The mere fact that you are investing in small pieces does not mean that you don't need to rebalance your portfolio, watch for changes in portfolio management or in the economic environment, etc. So part of the problem is not DCA itself, but the fact that other investment issues still need to be considered.

Conclusions

DCA does not provide any guaranteed return and/or risk reduction. It certainly does not work well in all market situations. Furthermore, research in the area indicates that lump-sum investing has tended to perform better over the longer term.

Nonetheless, DCA may be less stressful than a lump-sum investment, and if there is a major bear market around the corner, it has the potential to pay off. In some situations, it is an ideal way of managing both risk and stress.

You can also treat DCA as just one of the strategies that you use in your overall portfolio (in other words, it makes sense to use it as a form of diversification), but as with those other strategies, you still need to monitor, manage and rebalance your DCA investments.

Finally, depending on your individual situation, regular investing can be a lot better than no investing at all. If the choice is between investing $50 a month or treating yourself to an extra night on the town, it is clear which option has the potential to help see you through your old age.

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Dollar cost averaging does not ensure a profit and does not protect against loss in declining markets. It involves continuous investing regardless of fluctuating price levels. Investors should consider their ability to continue investing through periods of fluctuating market conditions.

Investing involves risk, including possible loss of principal. Investors should consider their own personal financial situation, investment goals, risk tolerance, investment time horizon and tax situation before investing. Please consult a financial professional regarding your specific financial situation before investing.

Diversification does not guarantee a profit or protect against a loss in declining markets.

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