

Dollar Cost Averaging

The term “Dollar Cost Averaging” is used to describe a situation where an investor makes regular ongoing contributions into an asset, such as a managed fund, rather than making a single lump sum investment.

Dollar cost averaging takes some of the risk out of investing in fluctuating markets as it removes the timing factor of deciding when to invest. The basis of dollar cost averaging is that you invest a set amount on a regular basis, irrespective of whether the market is up or down. There are two advantages to this:

- Seeing as investment markets fluctuate, it is difficult to choose the best time to invest. By investing on a regular basis, the risk of investing at the least favourable time is reduced.
- By investing the same amount each month, you can actually take advantage of market fluctuation. When the market is up, the value is higher so you purchase fewer units, shares etc. When the market is down, the value is lower so you purchase more units, shares.



Case Study

Assume that you have a total of \$10,000 to invest in a managed fund. Instead of a one off investment of \$10,000, you decide to invest \$1,000 every year. The table below shows the value of the investment over the 10 years:

Year	Opening Balance	Amount Invested	Rate of Return p.a.	End Balance
1	\$0.00	\$1,000.00	4.00%	\$1,040.00
2	\$1,040.00	\$1,000.00	5.00%	\$2,142.00
3	\$2,142.00	\$1,000.00	8.50%	\$3,409.07
4	\$3,409.07	\$1,000.00	1.75%	\$4,486.23
5	\$4,486.23	\$1,000.00	-3.75%	\$5,280.50
6	\$5,280.50	\$1,000.00	-1.50%	\$6,186.29
7	\$6,186.29	\$1,000.00	2.00%	\$7,330.01
8	\$7,330.01	\$1,000.00	-2.20%	\$8,146.75
9	\$8,146.75	\$1,000.00	4.20%	\$9,530.92
10	\$9,530.92	\$1,000.00	6.60%	\$11,225.96
Total		\$10,000.00		\$11,225.96

In the above example:

- Staying invested over the long term offers some protection from market volatility because your returns are averaged out over a number of years – the best return is in year 3 (8.50%); the worst return was in year 5 (-3.75%);
- You also benefit from compound interest. Compound interest is when you earn investment returns on both the principal value of your account as well as on interest previously earned.

At the end of year 10, you have invested a total of \$10,000. Your end balance is \$11,225.96 – a profit of \$1,225.96 (a return of **12.26%** p.a.).

In contrast, if you invested \$10,000 in year 10, your end balance would be \$10,660 – a profit of only \$660 (6.60%).

Apart from the benefits of dollar cost averaging, a regular investment plan offers several advantages:

- The discipline required is easy. You can arrange to have your regular investment amount deducted from your bank account every week/fortnight/month.
- You can invest small amounts.
- Your investment is flexible in that you can increase, decrease or stop your investment at any time.

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