

Dollar Cost Averaging: Myth or Viable Strategy?

Dollar cost averaging (DCA) is an investment strategy where fixed amounts are invested into the market at set intervals as opposed to making a one-off initial lump sum investment. The idea behind the strategy is that, by drip feeding regular amounts into an investment, an investor buys in at various unit prices and that over time the average unit price should be lower than if the investor had invested all their funds as a lump sum.

While not a new strategy, this method of investing is again gaining momentum as investors consider the best way of deploying excess cash back into uncertain and volatile markets. But does DCA actually work, or is it simply a clever marketing ploy to get people invested into the market? Many examples showing DCA use simulated data and do not reflect an investor's actual investment experience using DCA.

This paper investigates whether dollar cost averaging works across all market cycles and the considerations investors should take into account before commencing this strategy. The paper incorporates a case study utilising real unit price data, demonstrating how dollar cost averaging fares in different market environments.

Does DCA Work? —case study

The following case study assumes an investment into the Vanguard Australian Shares Index Fund. The example assumes a regular quarterly investment of \$500 on the 15th of the month (or next business day) commencing in March 2004. The unit price data has been sourced from Morningstar. Table 1 shows the amount invested at each interval, the relevant entry unit prices and the number of units purchased.

Table 1

	Amount Invested	Unit Price	Units
15/03/2004	\$500	\$1.32	379.59
16/06/2004	\$500	\$1.35	369.99
15/09/2004	\$500	\$1.41	354.13
15/12/2004	\$500	\$1.53	326.37
15/03/2005	\$500	\$1.64	304.12
15/06/2005	\$500	\$1.65	303.05
15/09/2005	\$500	\$1.76	284.22
15/12/2005	\$500	\$1.80	277.36
15/03/2006	\$500	\$1.93	259.00
15/06/2006	\$500	\$1.90	263.57
15/09/2006	\$500	\$1.93	258.42
15/12/2006	\$500	\$2.14	234.09
15/03/2007	\$500	\$2.25	222.39
15/06/2007	\$500	\$2.42	206.86
17/09/2007	\$500	\$2.38	209.80
17/12/2007	\$500	\$2.37	210.71
17/03/2008	\$500	\$1.93	258.53
16/06/2008	\$500	\$2.04	245.18
15/09/2008	\$500	\$1.81	276.85
15/12/2008	\$500	\$1.34	372.97
15/01/2009	\$500	\$1.30	385.36
16/02/2009	\$500	\$1.30	385.12
Total	\$11,000	\$1.80 Avg	6387.70

As shown in Table 1, the total amount invested into the Fund is \$11,000. The average unit price for the period is \$1.80 per unit, with a total of 6387.70 units being purchased (this case study does not take into account reinvestment of distributions or the impact of inflation).

In this scenario dollar cost averaging has not added value. The average unit price using DCA was \$1.80 per unit, compared to \$1.32 per unit had the investor invested all of their funds in March 2004. This difference is reflected in the number of units the investor ends up with using DCA versus a lump sum investment of \$11,000 in March 2004. Using DCA, the investor ends up with 6387.70 units compared to 8351.04 units had they invested a lump sum.

Does this mean that DCA does not work? As with most things, the answer is not clear. The period used in the analysis incorporates about three years of a bull market, which saw significant growth in the value of Australian shares. In an upward trending market such as this, DCA will not be as effective. This is because investors tend to purchase successive units at higher unit prices, therefore obtaining fewer units with each investment instalment.

In a falling market (that eventually rebounds!) DCA tends to work well. Using the same example and taking June 2007 as the starting point (a date commonly referenced as the starting point of the credit crisis), DCA has worked well. This was a period where the Fund's unit price was trending down. The Fund's unit price at the beginning of the period (15 June 2007) was \$2.42 per unit. In contrast, the average unit price using DCA, for the period from June 2007 to January 2009, was \$1.88 per unit.

Some considerations

One of the arguments against DCA is that for long-term investors, being invested in the market is the best strategy for building long-term wealth. The premise is that over the long term, growth assets do what they are intended to do—that is, grow. Certainly, being invested in the market is the optimal strategy over the long term, as the risk of missing out on short-term market rebounds can have a significant impact on the long-term return of a client's portfolio. While DCA may not always be an optimal long-term strategy, it may be a viable strategy over shorter timeframes (i.e. 6 months or 12 months) where there is heightened uncertainty regarding the direction of the market.

Most market commentators agree that we are likely to remain in a period of heightened market volatility, characterised by short market rallies and market dips. Given that the future direction of markets remains opaque, a DCA strategy may be a prudent strategy over the next 12 months, for those investors looking to enter or re-enter the market.

Other considerations investors should note when considering DCA include transaction costs that may be incurred with regular transacting, as well as the risk of overinvesting using a DCA strategy.

Conclusion

DCA has its place, particularly in periods of market uncertainty. Whether investors achieve a superior return outcome using a DCA strategy will depend on the prevailing market conditions. Downward trending or 'choppy' markets tend to suit a DCA approach; however, in rising markets the strategy does not work as well.

With cash rates trending down, investors will need to assess whether it is an appropriate time to start deploying cash into the equity market, as investors will struggle to meet their long-term investment objectives by being invested in cash. DCA is one investment strategy that continues to be useful for clients who are nervous about timing the market, or do not have sufficient capital to make a meaningful one-off lump sum investment.

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Date Prepared: March 2009
Analyst: Lukasz de Pourbaix
Release Authorised by: Amanda Gillespie

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