Pros and Cons of Dollar Cost Averaging

By www.ProfitableInvestingTips.com

Many investment advisors suggest that the average investor should use a technique called dollar cost averaging when investing. This approach lets you buy fewer stocks when the price is high and accumulate more when the price is low. It is a disciplined approach that avoids trying to time the market. By setting an amount that you want to invest every payday, month, or quarter, you set up an investing plan that is reliable and likely to succeed in accumulating wealth over the years. This having been said, what are the pros and cons of dollar cost averaging?

What Does Dollar Cost Averaging Mean?

Investopedia provides us with a formal definition of dollar cost averaging.

> *Dollar-cost averaging (DCA) is an investment strategy in which an investor divides up the total amount to be invested across periodic purchases of a target asset in an effort to reduce the impact of volatility on the overall purchase. The purchases occur regardless of the asset's price and at regular intervals; in effect, this strategy removes much of the detailed work of attempting to time the market in order to make purchases of equities at the best prices. Dollar-cost averaging is also known as the constant dollar plan.*

For those with no skill or interest in timing the market, this is generally a good choice.

What is Dollar Cost Averaging in Stocks?

While dollar cost averaging is generally used for investing in stocks it can also be used for investments like buying CDs or treasuries. However, the approach works best for stocks. In fact, if you are enrolled in a direct purchase plan for a stock, you can often buy fractions of shares which action then relieves you of the problem of buying more or less than you wanted. Many dividend reinvestment plans also include a direct purchase option.

Is Dollar Cost Averaging a Good Idea?

The value of dollar cost averaging is that it relieves you of the task of trying to time the market. But, it also leaves you open to blindly purchasing shares of a stock that you really ought to get out of. So, is dollar cost averaging a good idea for all stocks and all investors? The answer is no. Whenever you are invested in a stock you need to keep track of its intrinsic stock value and get out if the stock is not likely to grow and return profits over time. Dollar cost averaging helps keep you from buying excessively in a rising market and allows you to purchase more in a falling market. But, you need to make certain that the fundamentals of your stock warrant staying with that investment.

Why Do Investors Use Dollar Cost Averaging?

Smart investors use dollar cost averaging to ensure that they are investing at a steady pace over the years. They use this approach because it keeps them from buying excessively when shares are overpriced and allows them to accumulate more shares when prices are down. Not only does this approach help you avoid trying to time the market, but it also reduces the effects of fear and greed on your investing. Discipline is a necessity for successful long term investing and dollar cost averaging is a disciplined way to invest your money.

Power of Dollar Cost Averaging

The power of dollar cost averaging in your investments comes from two things. First, when you invest on a regular and steady basis you will generally realize the benefits of exponential growth with the regular appreciation of your stock. Second, when you have been purchasing the dollar value of stocks in a down market and the market recovers and surges, you will see a nice increase in the value of your portfolio. This approach can be especially powerful in volatile markets such as this year with the covid-19 crash and recovery. Anyone who did not panic but simply continued to invest as always has commonly been very pleased.

Reverse Dollar Cost Averaging

While you can build your portfolio using dollar cost averaging, what do you do when retirement comes and you want to reap the rewards of your disciplined investing? The answer is reverse dollar cost averaging. Sell the same dollar amount of shares every month or quarter and do not try to time the market. By leaving your money in the market you will still realize gains and in retirement you will not have to be bothered with trying to time the market to cover your expenses while you live the retirement life that you worked for and deserve.

How to Do Dollar Cost Averaging

For dollar cost averaging to work, you need to be invested in stocks or ETFs that reliably grow your wealth. So, you need to pick investments wisely and pay attention as you go. Alternatively, you can choose an ETF that tracks the S&P 500 or one of its sectors and very often do better than someone who tries to time the market, including many investment advisors. Pick a dollar amount that you can comfortably invest on a regular basis and stick with that amount for a year or so. If and when you have more to invest, do so. The key is to stay invested in good investments and invest on a regular basis for years and years!

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