Module 1 Article

The Power Of Dollar-Cost Averaging

Key Terms

- **Volatility**: Since the market is based on consumer sentiment, share prices change almost every second. Certain companies are more volatile, or subject to change in price, than others.
- **Passive Management**: This is an investing strategy that aims to build wealth over time. Generally, passive investing involves regularly purchasing shares in ETFs and index funds.
- **Margin of Safety**: This is a principle coined by legendary value investor Benjamin Graham. It proposes purchasing shares of a company at a discount to its inherent value, which is based on its assets, value proposition, yearly revenue, etc. Buying with a margin of safety is thought to minimize risk and increase returns.

Removing Human Error

Dollar cost averaging is a strategy that investors can use to mitigate the volatility that comes with a one-time large purchase of shares. Instead, the purchase is split across periodic intervals. There are two significant advantages associated with dollar cost averaging: it reduces emotion and speculation.

Dollar cost averaging takes human emotion out of the investment process. The draw to pull out of the market at the first sign of volatility is strong. However, with a pre-set investing schedule, market downturns will seem more like an opportunity to purchase your shares at a cheaper price, rather than a reason to bail out of the market entirely.

Even for seasoned investors, one of the biggest challenges in investing is timing the market. Moderate market swings are sometimes predictable based on current events, but it is often impossible to foresee drastic volatility.

Through dollar cost averaging, the risk of investing a large sum of money right before a downturn is mitigated. For example, if you entered the market right before the Covid-19 market crash, you would lose less money with dollar cost averaging than if you purchased a large chunk of shares all at once.

Remember Not To Get FOMO

That all seems pretty promising. However, dollar cost averaging isn't the end-all be all solution for winning in the markets. The nature of the market and passivity of the strategy make for some disadvantages that are important to consider.

One aspect of this strategy that may be unappealing is that, since the market compounds gains, a large sum invested all at once will generate higher returns than smaller sums invested over time. Depending on the length of your investing horizon the difference in returns could be significant.

In addition to lesser returns, dollar cost averaging also decreases your flexibility in the market. Companies are constantly coming up with new products, hiring executive staff, and generally making decisions that could affect their share price.

Dollar cost averaging disregards this aspect of the market, meaning you may miss out on increasing your position in a company before they achieve great success.

The Bottom Line

Dollar cost averaging is a great strategy for investors whose first priority is to reduce risk. It removes the challenge of timing the market as well as the fear that comes with market volatility.

For investors who are solely looking for high returns, dollar cost averaging may not be the best strategy, as it relies on smaller purchases that don't compound as much as lump sums. There are myriad investing strategies out there, of which dollar cost averaging is just one. Take time to understand other strategies and even combine some to fit your investing goals.