How Dollar-Cost Averaging Can Smooth Your Returns
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The market volatility of the past two years has left a lot of investors badly shaken. Even though stocks have rebounded significantly from the lows they hit in early March, just about everybody has lost a lot of money over the past year, and there's still plenty of uncertainty over whether the market has really hit bottom. Many people have retreated into low-risk investments such as Treasury bonds or cash while waiting out the market storm.

If you've stayed invested in the stock market, either directly or through mutual funds, it's natural to be looking for ways to smooth out your portfolio's returns going forward. And if you've retreated to the sidelines, you may be wondering if now is a good time to get back in. One way for both sets of investors to achieve peace of mind is through dollar-cost averaging, a simple, time-tested method for controlling risk over time. Dollar-cost averaging before is certainly a topic worth revisiting in light of the market's recent gyrations.

How It Works

The basic idea behind dollar-cost averaging is straightforward; the term simply refers to investing money in equal amounts at regular intervals. One way to do this is with a lump sum that you'd prefer to invest gradually--for example, by taking $1,000 and investing $100 each month for 10 months. Or you can dollar-cost average on an open-ended basis by investing, say, $100 out of your paycheck every month. The latter is the most common method; in fact, if you have a 401(k) or similar defined-contribution retirement plan, you've probably already been dollar-cost averaging in this way.

One reason dollar-cost averaging is so attractive is that it forces you to invest no matter what the market is doing, thus helping to avoid the poor decisions most people make when trying to time the market. When the stock market is going down, as it has over most of the past year, lots of people become fearful and reluctant to put money into stocks. That may help avoid some losses in the short term, but when markets eventually start going back up, as they have over the past month, someone who has avoided stocks will lose out on the gains. Those who invest a fixed dollar amount every month, on the other hand, will be in a much better position to benefit when the market bounces back, and meanwhile they'll often be buying stocks at bargain prices.

In a bull market, the opposite is true: dollar-cost averaging prevents you from getting carried away and putting too much money in stocks that may be too expensive and poised for a fall. In the raging bull market of the late 1990s, lots of otherwise rational people were swept up in the mania and loaded up on stocks trading at exorbitant prices; when the market crashed, many of those investors got badly burned. Investors who dollar-cost averaged into a stock portfolio missed out on some of the upside at the height of the bubble, but they were generally in much better shape when the market went south.

Why It's a Good Idea

As these examples show, dollar-cost averaging can help investors limit losses, while also instilling a sense of investment discipline and ensuring that you're buying shares at ever-lower prices in down markets. Numerous studies have confirmed that it also results in better returns than strategies that involve moving in and out of the market.

For example, one recent study by Fidelity looked at how several different strategies would have performed from January 2000 to January 2004, a period that included the previous bear market and the start of the subsequent recovery. The study found that the best results came from steadily investing $500 every month into an S&P 500 stock portfolio. This dollar-cost averaging strategy even outperformed a "bear-market dodger" strategy that started putting all its new money into cash in April 2000, at the height of the market bubble. Strategies that shifted into cash after the market had declined 20% (bear-market refugee) or at the market bottom (doomsday capitulator) did even worse.

It's still too soon to say how the current market turmoil will ultimately play out, but this bear market has been similar in depth to that of 2000-02 (albeit over a shorter time span). Certainly it's possible in retrospect to identify plenty of times over the past two years, such as the summer of 2008, when you would have been better off moving

temporarily into cash. Such times are only obvious in retrospect, though. Somebody who moved into cash in early March of this year, when market sentiment was arguably worse than last summer, would have missed the strong gains of the past month. The point of dollar-cost averaging is that it's impossible to predict the market's ups and downs accurately, and most investors who try to do so end up hurting their returns.

How to Do It

If you decide that dollar-cost averaging is a good idea, there are a number of ways to implement such a plan. If you're really disciplined, you can set one up on your own, figuring out how much you want to invest and then sending in a check each month. However, most people find it easier to stick to a dollar-cost averaging plan that's set up to work automatically. As noted above, most 401(k)s and similar retirement plans, such as 403(b)s, involve a form of dollar-cost averaging, as they take a fixed percentage of your paycheck and invest it in a prearranged group of funds or other investments. It's best not to mess around too much with the percentage you contribute to your 401(k). The advantages of dollar-cost averaging will be diluted or lost if you change this percentage in response to market conditions, for example, by cutting back your contribution when the market is going down.

Many mutual funds also have automatic investment plans that allow you to invest a fixed amount automatically every month. In many cases, the minimum initial investment needed to get into these funds is much lower if you set up an automatic investment plan; this makes such plans especially attractive for kids or recent college graduates who want to invest but don't have a lot of money up front. A fund's prospectus will tell you whether it offers such a plan, and you can also find this information on its "Purchase Info" page on Morningstar.com, where "Initial AIP" shows the minimum initial investment for an automatic investment plan. However, dollar-cost averaging may not be feasible if you have to pay loads or brokerage commissions every time you invest, so it's best to make sure that won't be an issue before you set up a plan.