

DCA still work?

Dollar Cost Averaging: A Second Look

By Bert Whitehead, M.B.A.

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“I don’t want to keep putting money in the stock market!” a client recently exclaimed. “It seems like my monthly savings gets wiped out in the next month...” Bill was determined to buy bonds instead; at least his money would still be there next month, plus a little interest.

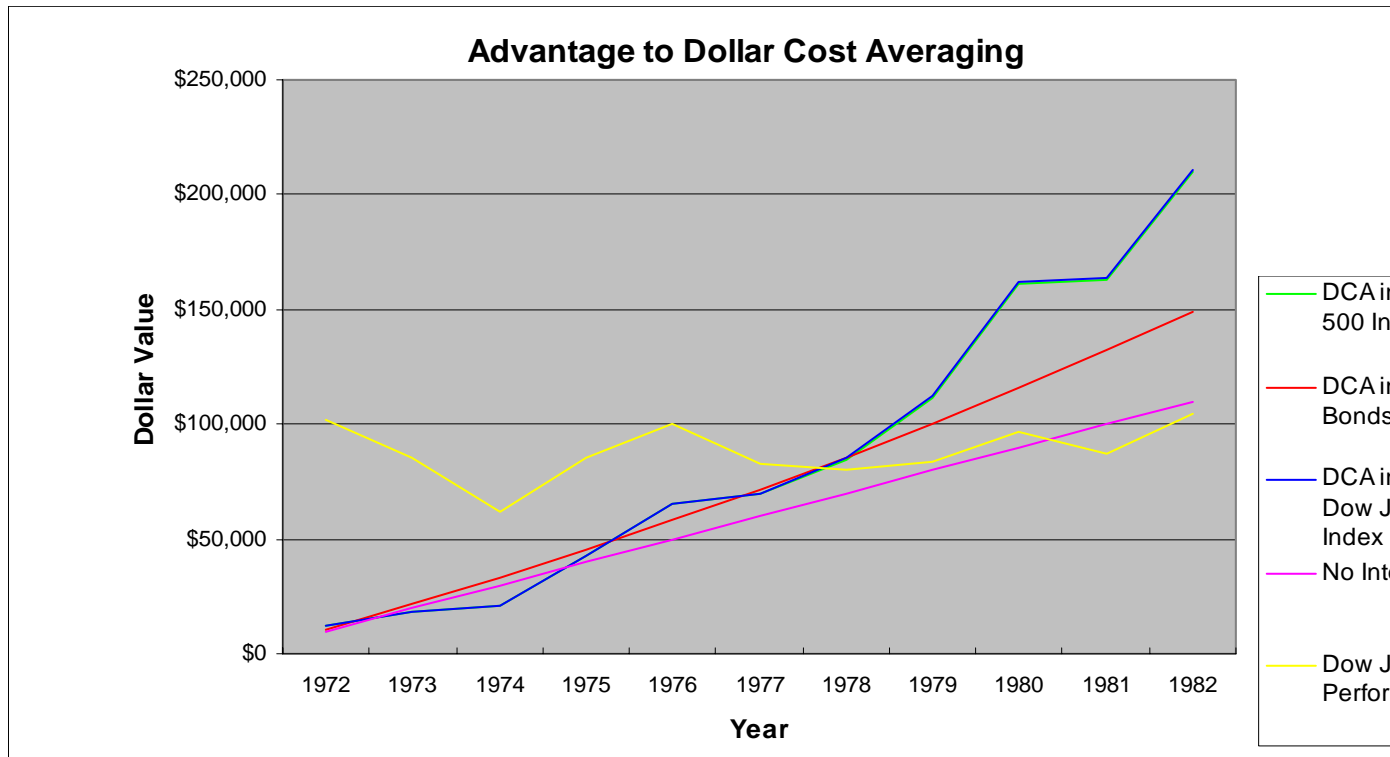
So the question looms: is it time to stop Dollar Cost Averaging (DCA)?

DCA is a strategy of investing a certain amount of money regularly on a monthly basis. This strategy protects the investor from a sudden drop in the market. Basically it assures the client that they will be buying into the stock market at the average price for the year. It is advantageous because when the market drops, each monthly investment buys more shares. When the market turns around, the portfolio rebounds quickly. DCA is an alternative to ‘market timing’ but it takes discipline.

Since Bill was a gambling man, he bet me \$100 that if he invested \$10,000 regularly each year during a recession into bonds paying 5% a year, at the end of 10 years he would be better off than if he Dollar Cost Averaged the same amount into the market during the whole recession. I took him up on the bet.

We agreed that the recession from 1972-1982 would be a good test. The Dow Jones Industrial Average closed above 1000 for the first time in 1972. Over the next few years it dropped about 40%, and then slowly rebounded and finally closed over 1000 again ten years later in 1982.

Jason Moore, my trusty Senior Paraplanner, did the analysis for us. His results are shown in the graph below. Using DCA into the Dow or S&P index during that period would result in a portfolio of 50% more at the end of the 10 years, even though we were in a recession.



The reason DCA beats bonds during a recession is that, while the stocks bought the first year are worth the same at the end of the 10 years, all of the rest of the stocks were purchased at lower costs. Indeed the stock purchased at the nadir of the recession (1974) increased over 60% in the next seven years!

Of course if the whole \$100,000 were invested all at once, instead of \$10,000 per year, the bonds would have superior performance. In that scenario, the bonds would increase at a 5% compounded rate to about \$175,000; the stocks would still be worth \$100,000 (plus perhaps some dividends).

As proponents of Functional Asset Allocation (explained in my recent book*), we eschew market timing which is the equivalent of gambling with investments. To protect an investor against deflation as well as inflation, and to participate in prosperous times as well, it is important to have assets properly balanced. A properly balanced investment portfolio includes a certain proportion of both stocks and bonds.

In scary economic times, it is more important than ever to continue a DCA program, even though instincts scream in protest. Many younger clients are using DCA as they contribute to their 401-k or 403-b tax deferred savings plan at work. It is tempting to switch all contributions, and even the accrued contributions, all into safe interest-earning investments. While this may be called for at certain points for

proper asset location, it is not an effective response to protect a portfolio in a declining market.

Your Cambridge Advisor will make sure that your portfolio is rebalanced regularly, and when you look back five or ten years from now you will appreciate that you had an advisor to keep your portfolio on track. It is difficult to maintain that kind of discipline without a trusted, unbiased personal financial advisor. Bill was grateful enough to pay up on his \$100 bet with me, but still hasn't started DCA... Yet.

This 'second look' is an assurance that DCA is still appropriate: Stay the course!

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*"Facing Financial Dysfunction: Why Smart People Do Stupid Things With Money" available through Amazon.com.

Bert Whitehead is the founder of the Alliance of Cambridge Advisors, and has been a practicing fee-only planner since 1972. He has been active in promoting NAPFA membership, and involved in moving Financial Planning toward becoming a true profession. He is author of the recent controversial book, "Facing Financial Dysfunction: Why Smart People Do Stupid Things With Money." This article can be quoted if the author is notified and appropriate attribution is noted in the text. Comments or questions about this article can be directed to: Bert@BertWhitehead.com

Balances