The Power of Dollar-Cost Averaging in a Volatile Market

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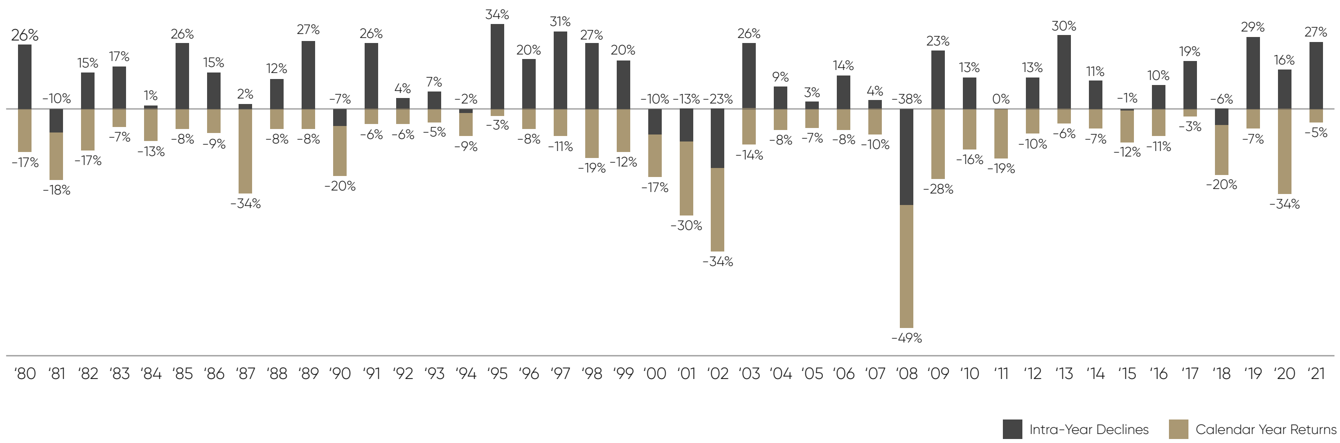
Stocks have been taking us all on a roller coaster ride this year with pandemic and inflation woes fueling the fire alongside the Fed's plans to raise interest rates as well. When the stock market is as volatile as it is right now, it can be a challenge to stay invested, not let our emotions get the best of us and to hold out for the long-term. But, it's important to remember that periods of volatility, even extreme levels of it, are not uncommon and if we are smart present amazing investment opportunities.

> **Be fearful when others are greedy, and greedy when others are fearful.**
>
> — WARREN BUFFETT

Over the last 22 years, we have seen stocks on the S&P 500 slip at least 10% or more during 14 of those years, yet in only six of them did we actually see net losses by the end of the year. Even despite these levels of panic-inducing volatility at times, the S&P 500 has still averaged a 7.09%-per-year return over that same 22-year time frame. Below is a chart that illustrates this:



In other words, those that stayed invested through these downturns still saw positive average returns overall during the same period. The truth is that volatility (aka periods of the market going up ↑ and down ↓) can actually be your friend if you know how to use it to your advantage.

However, since it's difficult, if not impossible to time the stock markets, the most effective way to benefit from volatility in the long-run is to use a straightforward investment strategy called "dollar-cost averaging". We are going to teach you everything you need to know about this simple strategy so you can harness its power in today's and future volatile markets.

What is Dollar-Cost Averaging?

Dollar-cost averaging refers to the practice of systematically investing equal dollar amounts over regular periods of time. For Example, if I had $12,000 to invest I might invest $1,000 each month over the course of a year. With Dollar Cost averaging the price of whatever you are buying is not taken into account in this instance because we know there's a high likelihood that prices will vary each time one of the periodic investments is made.

In general, you will buy at higher prices when markets are up, and lower prices when markets are down. The benefit of doing this is that it effectively removes our emotions from making investment decisions and it reduces our risk of over investing when the market is at a high and it allows us to maximize our investments when the market is undervalued (aka we are buying great companies at a discount).

You are more than likely already engaging in Dollar Cost Averaging. If you participate in your company's 401(k) plan, you make contributions to it out of every paycheck you receive. Those contributions then make regular, equal-dollar-amount purchases in the account, regardless of what the price of the target investment holding is when purchased.

How Dollar-Cost Averaging Works in Real Life

Let's assume your friendly neighbor, Jane Doe, works for XYZ Company where she participates in a 401(k) plan. Every two weeks, Jane receives a $3,000 paycheck and contributes 10% of it ($300) to her 401(k) plan where she buys a mutual fund. Over the course of a three-month period, Jane's purchases could look like this:

	Price of Mutual Fund	Contribution	Shares Bought	Shares Owned	Total Value
Paycheck #1	$20.00	$300.00	15.00	15.00	$300.00
Paycheck #2	$22.00	$300.00	13.64	28.64	$630.00
Paycheck #3	$15.00	$300.00	20.00	48.64	$729.55
Paycheck #4	$20.00	$300.00	15.00	63.64	$1,272.73
Paycheck #5	$25.00	$300.00	12.00	75.64	$1,890.91
Paycheck #6	$26.00	$300.00	11.54	87.17	$2,266.55
	Dollar-Cost Average	**Total Contribution**	**Total Shares Bought**	**Investment Value**	**Profit / Loss**
	$21.33	**$1,800.00**	**87.17**	**$2,266.55**	**$466.55**

As you can see, Jane invested a total of $1,800 over the three-month period. However, since the price of the mutual fund increased and decreased during that time frame, Jane's average price came to $21.33 per share, which is higher than her initial purchase of $20 per share, but lower than the fund's highest prices.

In this case, the price fluctuations played to Jane's advantage and she still ends up with a profit despite the volatility. In effect, dollar-cost averaging lowered Jane's basis in the mutual fund over the three month period and helped her avoid great losses when the fund's price was down while also generating greater gains when the price was up.

Other Benefits of Dollar-Cost Averaging in a Volatile Market

Outside of the mathematical benefits of a dollar-cost averaging approach in a volatile market, there are psychological benefits from the strategy as well. Dollar Cost averaging brings a disciplined approach to your investing because you are investing a consistent amount over a period of time. Investors who leverage consistent action are less likely to pay attention to daily price movements when strategically investing.

Leveraging the strategy of dollar cost averaging can help you avoid the counter-productive decisions that often stem from greed or fear, such as trying to time the market, buying too high, or selling too low when markets may fall. Successful investing requires getting comfortable with volatility and sticking to your investment strategy when times get tough.

Dollar-cost averaging is something you can easily automate, whether it's monthly contributions to your IRA or brokerage account, or it's the contributions to your 401(k) that get deducted from your pay every two weeks. If you put your dollar-cost averaging strategy effectively on autopilot, you're more likely to stay consistent, to minimize your emotional response to market fluctuations, and to achieve the results you desire.

Want help implementing your own dollar-cost averaging strategy? Schedule a virtual coffee meeting today with one of our expert wealth advisors to see what we can do!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Schedule a free consultation