Insights

Dollar Cost Averaging

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Like the pendulum that swings relentlessly back and forth, investor sentiment tends to alternate between periods of enthusiasm and despair. At times, investors can become guided by their emotions, allowing the mood of the market to dominate their investment decisions. It's extremely tempting to want to look for good times to get in or out of the market. But market history shows that a steady, consistent approach is a far more reliable way to meet your long-term goals.

> *"History and experience have proven that correctly predicting the timing and extent of stock market trends is impossible, because world developments and the psychological reactions of people are unpredictable."*
> —Thomas Rowe Price, Jr.

One effective strategy for overcoming the emotional hazards of investing is dollar cost averaging—investing equal dollar amounts at regular intervals, usually monthly or quarterly. This approach imposes a discipline that relieves the investor of grappling with uncertainty and volatility in the securities markets.

How it works—and why

Dollar cost averaging is a program of regular investing, and there are advantages in both the "regular" and the "investing" portions of that equation. First, the discipline of regular investing ensures that you won't drop out when the market turns bearish. The surest way to limit your long-term potential for investment gains is to drop out of the market for long stretches. Not only will you set aside less money over time for your investments, it is also likely that you will miss significant early gains when the market recovers.

Dollar cost averaging is also beneficial from an investment perspective because it is an automatic way to buy more shares when the price of an asset has declined or is low. The lower (in absolute or relative terms) a security's price, the more shares you will be able to buy with your regular investment. Buying low is an effective way to contain price risk and enhance your long-term potential for gains.

Table I illustrates a purely hypothetical example comparing two investors who started the year investing $200 each month. The investors could be purchasing shares of an individual stock or shares in a stock or bond mutual fund. (The variation among share prices shown here is more typical of stocks than bonds, however.)

Investor A stayed committed to the dollar cost averaging strategy, while Investor B succumbed to the temptation of suspending contributions after watching the share price fall for three consecutive months.

By investing steadily, Investor A accumulated shares and took advantage of subsequent gains. Because more shares were acquired when the share price fell and fewer were bought as it rose, Investor A's average cost per share, $9.41, is below the purchase price in seven months out of the year and significantly lower than Investor B's average share cost.

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Table I: Dollar Cost Averaging At Work: A Hypothetical Example					
		Investor A		Investor B	
Month	Monthy Investment	Price Per Share	Numbers of Shares Purchased*	Monthly Investment	Numbers of Shares Purchased*
January	$200	$10	20.00	$200	20.00
February	200	11	18.18	200	18.18
March	200	12	16.67	200	16.67
April	200	14	14.29	200	14.29
May	200	11	18.18	200	18.18
June	200	10	20.00	200	20.00
July	200	9	22.22	200	22.22
August	200	9	22.22	0	0.00
September	200	8	25.00	0	0.00
October	200	6	33.33	0	0.00
November	200	8	25.00	0	0.00
December	200	10	20.00	0	0.00
Total:	$2,400	$0	255.09	$1,400	129.54

A's Average Cost Per Share: $2,400 ÷ 255.09 = $9.41
B's Average Cost Per Share: $1,400 ÷ 129.54 = $10.81
A's Year-End Account Value: $2,550.90
B's Year-End Account Value: $1,295.40

*Rounded to two decimals.
This chart is for illustrative purposes only and does not represent an investment in any specific security.

By stopping contributions in July, Investor B may have thought that he "got out just in time," but in fact, he missed the opportunity to accumulate shares and take advantage of the rebound at the end of the year. The advantages of the dollar cost averaging strategy are striking when comparing the investors' net account values at the end of the year. Investor A had a net gain of approximately $150, while Investor B had a net loss of just over $100—the discipline of dollar cost averaging clearly paid off.

Getting started

If you are investing in mutual funds and reinvesting your dividend distributions, you are already using the principle of dollar cost averaging—your dividends will purchase more shares when the fund's price is lower and fewer shares when the price is higher. If you buy individual stocks, you can apply this principle by taking advantage of dividend reinvestment programs offered by many corporations. However, the reinvestment of stock dividends and mutual fund distributions is not a perfect example of dollar cost averaging since the amounts you receive will probably vary.

To invest a specific amount of money on a regular basis, you may want to consider systematic investment programs offered by many mutual fund companies. These programs can make automatic investments in a fund at fixed intervals by transferring money electronically from your checking account or, in some cases, your paycheck or a money market fund. You select the amount of money to be automatically invested, the time interval, and, of course, the mutual fund. This way, you don't have to remember to do it, and you don't have to exercise the discipline of setting aside the money for investing.

Of course, dollar cost averaging cannot assure a profit or protect against loss in a declining market. Also, since the program's benefits are realized over time, you should consider your financial outlook before you start and be prepared to stay the course during periods of low prices as well as high.

Insights reports provide background information on many aspects of investing. *Call 1-800-638-5660 to request a prospectus, which includes investment objectives, risks, fees, expenses, and other information that you should read and consider carefully before investing.* T. Rowe Price Investment Services, Inc., Distributor.

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