

understanding dollar cost averaging

WHAT IS DOLLAR COST AVERAGING?

Dollar cost averaging is an investment strategy to invest equal dollar amounts regularly and periodically over specific time periods into a particular investment or portfolio. By doing so, more shares are purchased when prices are low and fewer shares are purchased when prices are high.

The point of this is to lower the total average cost per unit of the investment, giving the investor a lower overall cost for the units that are purchased over time.

HOW DOES IT WORK?

We'll assume you want to invest \$5,000. You make a total of ten \$500 investments at regular intervals, as shown

in Graph 1. At the start, when the unit price is \$10, a \$500 investment buys 50 units. As the unit price falls, \$500 buys more units.

The results of this strategy are shown in Table 1.

In our example, the \$5,000 investment will result in your acquiring 892 units over the 10 periods, which at the end of period 10 will be worth \$8,916, a gain of 78 per cent.

This compares to the zero profit that would have been achieved if the \$5,000 was fully invested at the start of the bear market.

ADVANTAGES

When prices are high, your money buys fewer units, and when prices are

low, your money buys more. Over time, because markets fluctuate, you will probably end up with more units at lower prices than if you bought them all at once. It reduces your average unit cost and spreads your investment risk over time.

For many people, their superannuation contributions include an element of dollar cost averaging, because their employers automatically contribute a predetermined amount of money each month into their super fund.

However, dollar cost averaging is not limited to superannuation plans. It can be applied to other investment programs as well.

The discipline of investing a fixed amount each month can help reduce the volatility of a portfolio and maximise long-term growth by systematically buying the same dollar amount of a managed investment each month.

In a falling share market environment, the greatest risk is not necessarily investing; the risk is more likely to be not investing.

Graph 1: The effect of price on the number of units purchased, over time

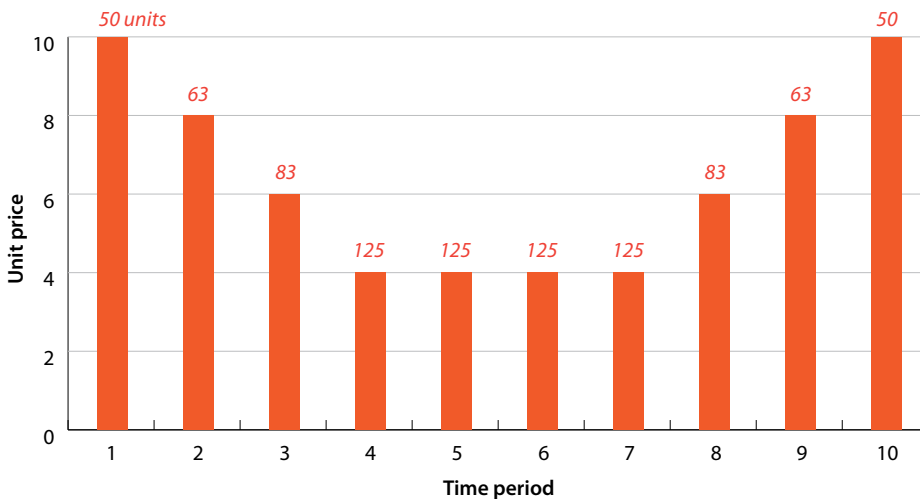


Table 1: The effect of dollar cost averaging

Timing Decision	Amount Invested	No. of Units Purchased	Value at End	Net Gain
Dollar Cost Averaging	\$5,000	892	\$8,916	\$3,916
Invest \$5000 at Period 1	\$5,000	500	\$5,000	\$0
Invest \$5000 at Period 10	\$5,000	500	\$5,000	\$0



This article by Patrick Bennett (above), Head of Research.

DISADVANTAGES

This method of investing can be a good risk reduction strategy during times of market volatility or uncertainty. However, dollar cost averaging does not assure a profit or protect against a loss in a declining market. Generally, there is no investing strategy that 100% can guarantee that you will make a profit.

Averaging down works well when the asset eventually rebounds because it has the effect of magnifying gains, but if the stock continues to decline, losses are also magnified. Investors need to take care assessing the risk profile of the investment. In this instance, we strongly recommend investing in a broadly diversified portfolio of assets rather than a single stock.

Another drawback of averaging down is that it may result in a higher-than-desired weighting of a sector in an investment portfolio. If dollar cost averaging is applied only to the equities part of a portfolio, it is important that the portfolio is rebalanced from time to time to ensure that the overall portfolio risk profile is maintained to avoid putting the investor at higher risk.

IMPLEMENTING DOLLAR COST AVERAGING

Deciding on the right price at which to purchase a security represents one of the major difficulties that investors face. Dollar cost averaging can take some of the emotion out of investment decision making.

During periods of share market volatility, the inclination of many investors is to wait until things settle down. Alternatively, investors may be lured into trying to pick the top of the market cycle, or when the bottom of the market has been reached in an attempt to invest at the optimal time.

It is important to maintain an investment discipline. You must continue to purchase shares both in market ups and downs for the strategy to be effective.

The principle of dollar cost averaging provides a means of reducing the risk of investing during a period of market volatility. It helps to overcome the 'investor paralysis' often associated with a falling share market and offers the potential of participating in the purchase of assets at reduced prices.

In order to begin a dollar cost averaging plan, you need to do three things:

1. Decide exactly how much money you can invest each month. Make certain that you are financially capable of keeping the amount consistent; otherwise the plan will not be as effective.
2. Select the investment that you want to hold for the long term, preferably five to ten years or longer.
3. At regular intervals, invest that money into the selected investments. If possible, set up an automatic withdrawal plan so the process becomes automated.

The rest is left to the market. You do not have to think about the right time to invest since you will be making regular investments.

It is important to maintain an investment discipline. You must continue to purchase shares both in market ups and downs for the strategy to be effective. Lapsing into market timing will undermine the effectiveness of the strategy.



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