Dollar Cost Averaging – When Does it Make Sense?

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Putting a large sum of cash into the market can be nerve-racking. What if the market goes down right after you buy? Should you wait for the market to go lower and buy then?

It would be great if we could buy all of our investments when the market is low and sell when the market is high. Unfortunately, efforts to 'time the market' often backfire to the detriment of long-term investors and have been proven to be very hard to accomplish.

Instead, there are two sound strategies that investors can take when introducing money into the market. The first is dollar-cost averaging and the second is to invest in one fell swoop.

What is dollar cost averaging?

Dollar-cost averaging is a strategy of investing money into the market proportionally over a period of time. Your money is invested in equal parts based on a time period that you decide upon.

Dollar-cost averaging helps to smooth out short-term market impacts of investing your cash and it removes the psychological fear of investing right before a downturn. By building up your position over time, you minimize the risk of an unknown event sending the market lower right after you get started. Whether the market moves up or down, when you invest each period you "average" in based on the prevailing prices.

How it works

To dollar cost average, you break your total investment into pieces and put a portion in each time period. Say, for example, that you had $500,000 to invest and chose a period of five months to get invested. Each month, regardless of how the overall economy or market was behaving, you would put $100,000 to work.

Here is an example of dollar cost averaging $500,000 over such a period of time:

Dollar Cost Averaging - Straight Line

Total cash to invest: $ 500,000

	Month 1		Month 2		Month 3		Month 4		Month 5		Month 6	
Time Period	$ to invest	%	$ to invest	%	$ to invest	%	$ to invest	%	$ to invest	%	$ to invest	%
6 Months	$ 83,333	17%	$ 83,333	33%	$ 83,333	50%	$ 83,333	67%	$ 83,333	83%	$ 83,333	100%
5 Months	$ 100,000	20%	$ 100,000	40%	$ 100,000	60%	$ 100,000	80%	$ 100,000	100%		
4 Months	$ 125,000	25%	$ 125,000	50%	$ 125,000	75%	$ 125,000	100%				
3 Months	$ 166,667	33%	$ 166,667	67%	$ 166,667	100%						
2 Months	$ 250,000	50%	$ 250,000	100%								
1 Month	$ 500,000	100%										

Pros and cons

The benefit of dollar-cost averaging is that you reduce the risk of an unknown event causing a severe sell-off right after you invest the capital. It smooths out the impact of short-term volatility and gives you the opportunity to invest at lower prices should the market be bumpy or suffer a severe downturn. There is also the psychological benefit of creating a plan to help to overcome the inertia of getting started, which can be particularly true if the sum is a large percentage of your total net worth.

An example of a time when dollar-cost averaging can be favorable is the 2022 bear market, which has been extremely volatile. In such an environment, dollar-cost averaging leads to lower entry points for most investment periods.

The alternative to dollar-cost averaging is to invest all your money in one fell swoop, with the rationale that the market goes up more often than it goes down over the long run. If you dollar-cost average and the market moves higher early on in your dollar-cost averaging period or is not very volatile, you will miss some of the upside during that period.

An example of a time when investing one lump sum was favorable is 2021 when the market climbed steadily higher with few drawdowns for the entire year.

When is it worth it?

The data suggest that over the long-run, dollar-cost averaging is not more beneficial than investing all at once in a lump sum. That said, there are times when we believe dollar-cost averaging is the right approach. During times of heightened volatility, when there is higher than normal probability of binary market outcomes (big event-driven upside or downside), dollar-cost averaging could be the correct decision from a risk management perspective, despite being mathematically less favorable over the long-run. Additionally, you could structure your dollar-cost averaging plan to dynamically adjust should market conditions change. For example, if the market were to sell off 10% or more, you might invest a larger portion or all the remainder of the cash and lock in the lower prices.

Your circumstances and preferences will help determine which strategy is right for you. Our goal as advisors is to help provide context that enables you to weight the pros and cons for your specific situation.

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