DOLLAR COST AVERAGING

TIMING RISK

Share markets are bumpy. Even when times are good, prices in larger companies can rise and fall on a daily basis.

This creates the risk – known as 'timing risk' - that an investor might buy shares on a day when prices are temporarily high. Doing this is bad news for two reasons: the value of their investment may fall; and they will purchase fewer shares for a given amount of money. So, when the market recovers, they won't do as well.

MANAGING TIMING RISK

The best way to manage timing risk is to purchase shares at multiple points of time. This is known as *dollar cost averaging*. Just like diversifying a portfolio reduces the effect that any one company's performance has on that portfolio, dollar cost averaging reduces the effect of any particular day on which an investment takes place.

Let's say an investor has $120,000 to invest. If she invests that money all at once, she creates the risk that she will invest 100% of her portfolio at relatively high prices. A better way to go is to divide her investment into 12 $10,000 portions and then invest one portion each month over a year. Some months, prices will be high and she will buy fewer shares. In other months, prices will be low and she will buy more shares.

WHEN TO USE DOLLAR COST AVERAGING

Dollar cost averaging should be used when you are investing a substantial amount of money over a long-term. Dollar cost averaging works best when a market is falling. It works least well in a market is rising. The problem is, no one knows whether the market is about to rise or fall. And most people think that the advantages of dollar cost averaging in a falling market outweigh the disadvantages of dollar cost averaging in a rising market.

Dollar cost averaging is usually done when investing in share or share based investments. This is because it is possible to purchase smaller portions of this type of investment.

AUTOMATIC DOLLAR COST AVERAGING

Lots of people already use dollar cost averaging without knowing it. This is because regular employer contributions into a super fund are then invested into the sharemarket at multiple points in time.

What's more, because super contributions occur over many years, the dollar cost averaging also takes place over many years. This is about 'as good as it gets' when it comes to reducing timing risk.

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