Strategy 4

Dollar cost averaging: taking the guesswork out of investing

When investing for the long term, it may be wise to contribute a fixed amount on a regular basis.

What are the benefits?

By using this strategy, you could:

- Use the ups and downs in investment markets to your advantage, and
- Take the guesswork out of trying to pick the 'right' time to invest.

How does the strategy work?

This strategy involves investing a fixed amount at regular intervals (eg monthly) over a period of time – regardless of whether prices go up or down.

It's called dollar cost averaging and it can work particularly well with managed investments, such as a unit trust.

Assuming you invest a set amount in a unit trust each month, you can buy more units when prices fall and fewer units when prices rise.

As a result, you can average the price you pay for your investments and potentially profit from a fluctuating market.

Let's say, for example, that:

- You invested $200 per month in a unit trust share fund over a five-month period, and
- The unit price dropped from $10 to $5, before returning to $10 at the end of the fifth month (see table below).

You may think it would be hard to make any money when the unit price ended up at exactly the same point as it started.

However, your monthly investment of $200 would have bought more units when the price declined and reduced the average price you paid to just $7.14 per unit.

By using this strategy, you would have acquired a total of 140 units and your investment would have been worth $1,400 at the end of this period.

As a result, drip-feeding your money into the unit trust would have enabled you to make a profit of $400 when compared to your total outlay of $1,000.

Note: Dollar cost averaging doesn't guarantee a profit or protect you against a loss, particularly if you are forced to sell when the market is falling.

Month	Monthly investment	Unit price	Units purchased
1	$200	$10.00	20
2	$200	$6.66	30
3	$200	$5.00	40
4	$200	$6.66	30
5	$200	$10.00	20
Total	**$1,000**		**140**

Average price paid = $7.14 (ie $1,000/140 units)
Investment value at the end of five months = $1,400 (ie 140 units at $10 each)

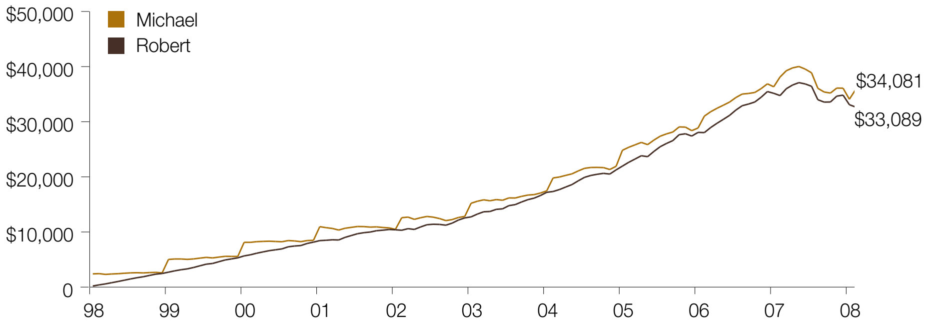
Case study

Robert and Michael each want to invest $2,400 a year for 10 years in a balanced fund (via a unit trust). Robert decides to use dollar cost averaging and arranges for $200 to be transferred from his bank account at the end of each month.

Michael, on the other hand, decides to invest his $2,400 as a yearly lump sum when he thinks the market is at its lowest. That way, he can purchase more units with his money. After spending a lot of time monitoring unit prices, Michael surprisingly ends up investing at the lowest price every year. But was it worth it?

Despite all Michael's hard work over the 10 years, there is only $992 difference between the value of their investments, as the graph below reveals. This also assumes Michael is lucky enough to pick the best time to invest each year – a difficult task that could easily have backfired.

Value of $24,000 invested over 10 years



Note: Year ended 31 December

The performance indices used in the graph above are: Australian Shares: S&P/ASX 200 Accumulation Index (All Ordinaries Accumulation Index prior to April 2000), Global Shares: MSCI World Gross Accumulation Index ($A), Property: ASX 200 Property Accumulation Index (Property Trust Accumulation Index prior to July 2000), Australian Bonds: UBS Composite Bond Index – All maturities (Commonwealth Bank Bond Index prior to November 1987). All earnings are re-invested but do not take into account the impact of fees or taxes on distributed income and capital gains. This example is based on historical performance and is not indicative of future performance. Future performance is not guaranteed and is dependent upon economic conditions, investment management and future taxation.

Tips and traps

- An easy way to implement this strategy is to pay yourself first (ie invest a fixed amount of your salary each month before you spend your money on other things).
- You can purchase units in a unit trust automatically by arranging to have money transferred directly from your nominated bank account or salary. Direct debit is offered by most financial institutions and fund managers.
- By re-investing your income to purchase additional units, your regular investments can benefit from the power of compound returns (see Strategy 1).
- To accelerate the creation of wealth, you could consider instalment gearing, which allows you to supplement your regular investments into a unit trust with regular drawdowns from an investment loan (see Strategy 8).