

Dollar Cost Averaging May Minimize Risk in a Volatile Market

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Do you ever run away from a sale? In an example of how irrational investors can be, consumers who react positively to a 25% off sale on apparel or sporting goods are often the same shoppers who flee when the market is on sale. Why? When the market climbs, investors perceive their only risk as not investing fast enough to benefit from certain gains. And when the market plummets, the prevalent fear is that stocks will slide even lower.

Of course, if recent volatility has taught us anything it's that the market is, indeed, unpredictable. Somebody who moved into cash in early March of this year, when market sentiment was arguably worse than last summer, would have missed the strong gains of the past month. Accordingly, rather than make misguided attempts to time your investments to hit market upswings, the best approach is simply to do your best to control the inevitable volatility. An investment strategy known as dollar cost averaging can be especially effective during a market downturn.

Dollar-cost averaging involves investing a fixed dollar amount at pre-determined intervals, as you do with your 401(k) plan. Naturally, your set monthly contributions buy fewer shares when the market is up and more shares when the markets are down, resulting in an average cost per share over time.

Today, even the most disciplined investors, fearful that the market will decline further, are questioning whether it's wise to stick with dollar cost averaging and continue to make their regular market contributions to 401(k) plans and IRAs. However, studies* have proved that dollar cost averaging may result in better long-term returns than strategies that involve moving in and out of the market, or "market timing."

A recent Fidelity study, for example, evaluated how various market timing strategies would have compared to simply sticking with a plan to invest \$500 each month into an S&P 500 Stock portfolio from January 2000 to January 2004, a period that included the technology bubble and the beginning of the market's recovery. Fidelity found the "Stay-the-Course Investor" who maintained a dollar-cost averaging approach throughout the period fared better than the "Bear Market Dodger" who shifted 100% of new contributions to cash before incurring any losses, and moved 100% of new contributions back into stocks as the market resumed a long-term uptrend; the "Bear Market Refugee" who shifted all new contributions to cash at the onset of a bear market (20% drop), and 100% of new contributions back into stocks as the market resumed a long-term uptrend; and the "Doomsday Capitulator" who shifted 100% of new contributions to cash at the bear market's cyclical low point, and 100% of new contributions back into stocks as the market resumed a long-term uptrend. The S&P 500 Stock index is a widely recognized, unmanaged index of common stocks. Indices are unmanaged, statistical composites and their returns do not include payment of any sales charges or fees an investor would pay to purchase the securities they represent. Such costs would lower performance. It is not possible to invest directly in an index.

While the discipline of dollar cost averaging helps take emotions out of the investing equation, the strategy does not advocate operating on auto-pilot. Especially in this volatile market, you need to review your accounts and rebalance more frequently. If you have moved 401(k) assets to low-risk investments such as Treasury bonds to ride out the market storm, you may want to start moving back into a more aggressive allocation. Moving your assets a little at a time via dollar cost averaging, rather than all at once, helps reduce your risk. You might also decide to keep existing assets invested in a conservative fashion to preserve your wealth, but take on more risk with your new regular contributions.

If your company has stopped matching your 401(k) contributions, you may need to develop a plan to save more on your own. Don't stop contributing to the account, and even increase your contributions if at all possible. It could be worthwhile to also set up automatic contributions to an investment plan in addition to the 401(k) such as a mutual fund or IRA account. However, tax deductions can only be claimed on the higher of the two accounts, so it's wise to speak with a financial advisor and tax consultant to determine the best strategy.

Finally, if you've retreated entirely to the sidelines, dollar cost averaging could be a lower risk way to get back in to the market. As markets start going back up, investors who keep avoiding stocks will not participate in the gains. If, however, you invest a fixed dollar amount every month, you will be much better positioned to benefit from the market's eventual rebound.

Especially in a recession, dollar cost averaging remains a long-term investing strategy that helps eliminate the potentially harmful temptation to try to time the market. Sure, it's possible that the market will retreat further in the coming months, but in the eyes of a disciplined dollar cost averager, the decline presents an ideal buying opportunity. As any Costco shopper will tell you, it feels great to get more for less.

*Source: http://www.mfea.com/NewsCommentary/Archived/Commentary/FidelityStrategy_092408.asp

Dollar cost averaging involves continuous investment in securities, regardless of the fluctuating price levels. Investors should consider their ability to continue purchases through periods of low price levels or changing economic conditions. Such a plan does not assure a profit and does not protect against loss in declining markets.

About Brett Ellen and American Financial Network

Brett Ellen, founder and president of American Financial Network, is a financial planner and investment advisor representative with Securities America Advisors who specializes in wealth management and corporate benefit planning services. Additionally, Ellen established and is an active part of the Financial Solutions Alliance, a network of financial service providers from across the country that work collaboratively to address the financial and business needs of their clients. Unprecedented in his ability to serve both individual investors and corporate planners, Ellen is recognized by Securities America as their top advisor.

As a California native, Ellen believes strongly in giving back to his community. He and his firm actively support a variety of non-profit organizations. In 2008, the Muscular Dystrophy Association awarded Ellen the prestigious Humanitarian of the Year Award for his philanthropic endeavors and dedication towards making a difference. In 2001 he and his wife, inspired by their children, formed their own non-profit. TKOHelpingHands.org (Turn Kindness On) promotes community involvement and social responsibilities in young children. Ellen also writes a finance blog for children - www.KidsFinanceCoach.com - to help them understand important concepts and become financially literate and responsible adults. For more information about Brett Ellen, visit www.afn-net.com.

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