Key Investment Concepts

Dollar cost averaging

Aon Hewitt Financial Education Series

Many successful investors build wealth slowly over time by remaining invested for the long-term and ignoring short-term market volatility. Yet some of us find that watching the value of our investments rise and fall from month to month in line with market volatility can be distressing. There is however, an investment strategy that usually limits the impact this volatility has on your investment return. This strategy is known as dollar cost averaging.

How does this work?

Using the dollar cost averaging investment strategy, an investor regularly buys into the investment markets of their choice, regardless of whether they are rising or falling.

As we know, investment markets are volatile and prices fluctuate from day-to-day, therefore the unit price of an investment say in the Australian share market will also fluctuate from day-to-day.

If you are someone wanting to invest in the Australian share market you could decide to make regular contributions, for example $100 per month, into a super fund investing in companies listed on the Australian Stock Exchange. By regularly investing, you are able to limit the impact of short-term market volatility on your investment return.

In the example mentioned, each month over a 12 month period, the $100 regular contribution is used to buy units in the super fund. Each month the unit price varies, therefore the number of units purchased also varies.

To illustrate, in January, the unit price was $1.00 so the $100 contribution bought 100 units. In February, the unit price had risen to $1.15, so that month's $100 contribution bought 87 units. The total 187 units could be sold for $1.15 each so the value is $215. This process continues over the year. When the unit price rises, fewer units are bought and when the price falls, more units are bought.

The summary is as follows with the accompanying table:

- Number of units purchased over the year: 1,260
- Total cost over the year: $1,200
- Total value of investment at end of year: $1,260
- Profit: $60

Month	Amount Invested	Price Paid Per Unit	# of Units Purchased	Total Units	Total Investment	Total Value of Investment
January	$100	$1.00	100	100	$100	$100
February	$100	$1.15	87	187	$200	$215
March	$100	$0.95	105	292	$300	$278
April	$100	$0.84	119	411	$400	$345
May	$100	$0.79	127	538	$500	$425
June	$100	$0.82	122	660	$600	$541
July	$100	$0.95	105	765	$700	$727
August	$100	$0.99	101	866	$800	$857
September	$100	$1.02	98	964	$900	$983
October	$100	$1.01	99	1,063	$1,000	$1,074
November	$100	$1.03	97	1,160	$1,100	$1,195
December	$100	$1.00	100	1,260	$1,200	$1,260

The unit price of the super fund began at $1.00 in January and finished at $1.00 in December. However, over the year, the unit price ranged from a high of $1.15 to a low of $0.79 in line with market volatility.

By regularly buying units every month regardless of market volatility, the average price paid per unit showed much less variation or volatility than the actual unit price over the year i.e. the average price paid per unit was much steadier.

The average price paid per unit by the end of the year was $0.9524 (the total cost of $1,200 divided by the 1260 units bought) but the market value of each unit was $1.00. You have therefore made a profit over a year of high market volatility. This was possible because the market value of the units at exit from the fund exceeded the average price paid per unit.

Dollar cost averaging smooths the impact that rises and falls in investment markets have on your investment return.

What would have happened if you invested an equivalent amount of $1,200 at the beginning of the year by comparison?

Over the first two months you would have a greater profit by making a lump sum investment compared to implementing the dollar cost averaging investment strategy. However, when markets fell during March, April and May, you would have made a greater loss. Overall, during the year, the dollar cost averaging strategy resulted in less time spent in a loss making position than the lump sum investment strategy.

Although dollar cost averaging smoothes the gains you make in a rising market, the strategy also helps to protect your capital by limiting the losses you make in a falling market. The overall trend is for investment markets to rise over time, however, most of us find that any protracted downward movement in the markets causes us to worry about whether this is in fact the case. By using the dollar cost averaging investment strategy, you gain peace of mind. When markets go down the value of your investment will fall also, but your loss will be considerably reduced.

Dollar cost averaging is a risk reduction investment strategy. During falling markets, dollar cost averaging reduces losses.

Aon Hewitt Financial Advice Limited | ABN 13 091 225 642 AFSL No 239183

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