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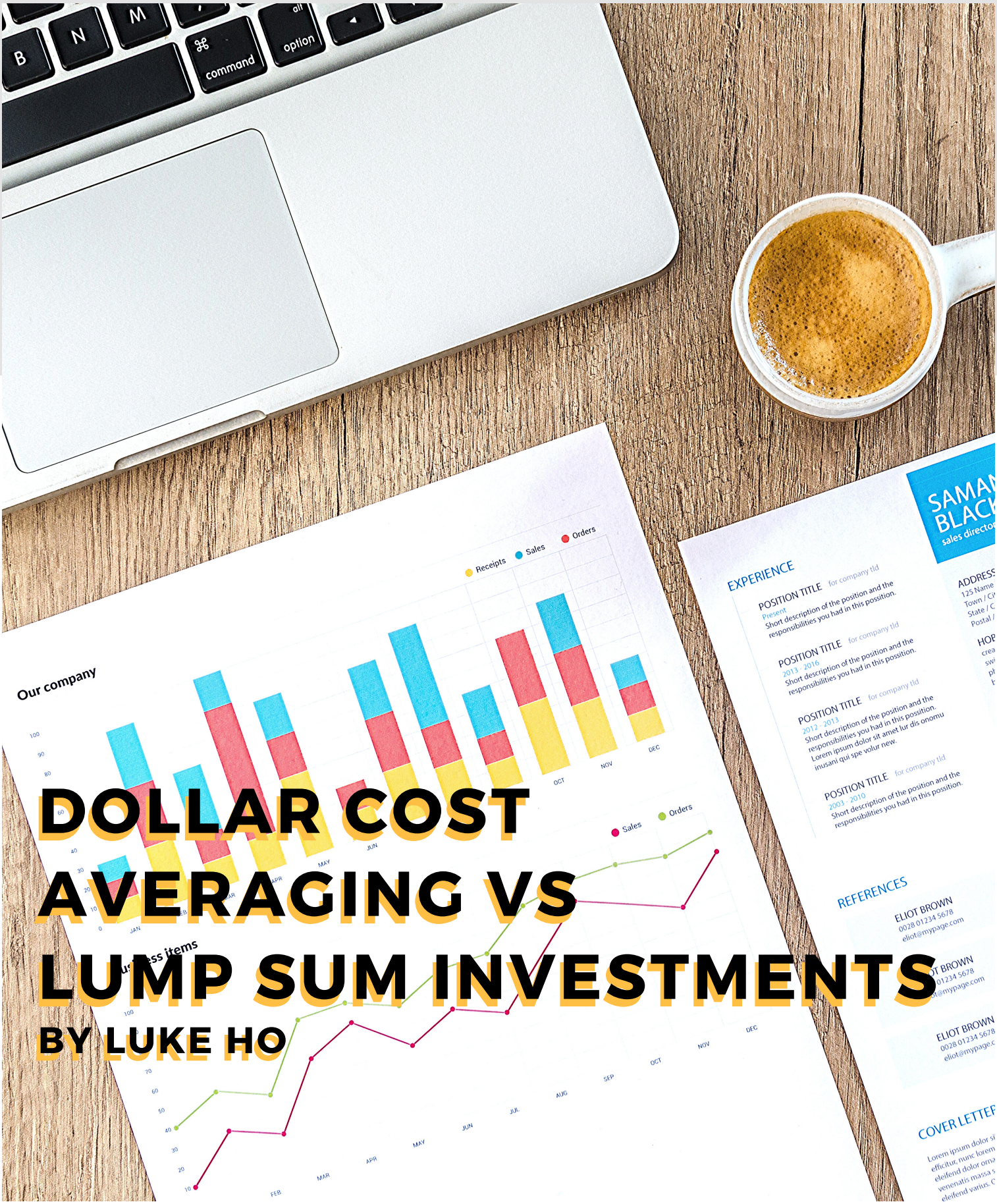

DOLLAR COST AVERAGING VS LUMP SUM INVESTMENTS

BY LUKE HO

DOLLAR COST AVERAGING VS LUMP SUM INVESTMENTS

The act of investing has always been cast in doubt due to exceptionally painful stories of people who have lost it all.

This is especially painful for consumers to view because investing is a legal, regulated and typically beneficial act for the economy – compared to something where you would expect such an outcome, like gambling.

As a result, it is important for consultants to understand how to manage risks in investments.

Unfortunately, consultants also have the task of adding value to a client's return – where end results are often viewed as the most valuable indication of whether a consultant is a successful one or a failed one.

Therefore, consultants need to learn how to strike a balance between creating return and managing risks – as well as some of the basic investment strategies that are typically involved in such a process.

There are two basic ones: 'Dollar Cost Averaging' and 'Lump Sum Investing.'

Dollar Cost Averaging: Risk Management

Dollar Cost Averaging is the art of investing portions of your money at regular interval in order to manage risk.

This strategy is statistically proven to manage risk in markets where values are ever changing so regularly, and is **especially effective when markets are falling.**

Take for example, the dot.com crash from 2000 to 2002.

If you had invested a lump sum of $300,000 at the beginning of 2000, you would have purchased the units at $1425.59 each, and you would own a total of 210.44 units.

Comparatively, even with your capital of $300,000, you only invest $100,000 each year for the next 3 years – you would own a total of 232.72 units instead.

Jan 1, 2002	1,140.21
Jan 1, 2001	1,335.63
Jan 1, 2000	1,425.59

Price of SNP500 between 2000 – 2002

If you bought absolutely nothing else and held them to the end of 2017, where each unit was now worth almost $2790...

...Dollar Cost Averaging would have made you over $62,000 than Lump Sum Investing.

LUMP SUM INVESTING: CREATING RETURN

On the other hand, Lump Sum Investments have had statistically better results at creating return – approximately 2/3rds of the time.

This might seem like a particularly controversial statement, especially to senior consultants – but the data compiled by Vanguard studies* has verified this more than once, and said experiment has been repeated by finance studies from universities endlessly.

There are exception cases like the above, but a very basic example can be demonstrated here in this 20-year timeframe of the SNP500, using a $400,000 capital.

2017	19.42%	2007	3.53%
2016	9.54%	2006	13.62%
2015	-0.73%	2005	3.00%
2014	11.39%	2004	8.99%
2013	29.60%	2003	26.38%
2012	13.41%	2002	-23.37%
2011	0.00%	2001	-13.04%
2010	12.78%	2000	-10.14%
2009	23.45%	1999	19.53%
2008	-38.49%	1998	26.67%

SNP500 Returns: 1998 - 2017

As you can see from the example, there is significant volatility within this 20-year period. From initial inspection, it would be easy to conclude that Dollar Cost Averaging might use a capital of $400,000, the difference was massive.

The results?

Lump Sum: $400,000 --- $1,101,940 [Result: 5.197% annualized]

DCA: $20,000 x 20 --- $826,607 [Result: 6.496% annualized]

On paper, the lump sum performed about 1.3% **lower** than Dollar Cost Averaging.

But it also made almost **Three Hundred, Thousand Dollars** more. [$300,000]

KEY TAKEAWAYS

1. **Lump Sums Investing tends to give Higher Returns in Most Long Term Scenarios.**

   To quote the Vanguard study:

   '...this temporarily cash-heavy asset allocation is much more conservative than the investor's true target allocation (the one that will exist after the DCA period) and that, while this short-term deviation from the target provides some relative protection from market downturns, it does so by sacrificing some potential for greater portfolio gains.'

   You can replicate this if you compare a yearly investment to a monthly investment as well.

   Yearly will typically do better over time.
   This doctype is meant to help our users create various business or project proposals and help them get approved. Proposals themes can be categorised per industry.

2) DCA Helps Mitigate Risk...in the Short Term, and Bear Markets

For clients that are uncertain, DCA does it's job by helping to mitigate risk.

Especially now, where we face the late stage market cycle and increased probability of a market crash – your clients may opt to take a more cautious approach to their investments through both their injection of money (DCA) and asset allocation.

KEY TAKEAWAYS (CONT'D)

3) Risk and Return needs to be Balanced

We tend to write off low-yielding investments very easily just by looking at the numbers, but studying the volatility of the investments and what strategies may work better for that person and that time in the market.

This helps open up more options for us as consultants, so that we can help with not just high returns - but the risk adjusted returns for our clients who can experience both comfort and returns.

Context is also very important, as I've demonstrated above in both examples.

A lump sum outperforms despite being a whole percentage point lower in Return on Investment. If you've kept away from the market, waiting for a crash and did better in terms of ROI, you still might not have done better in absolute returns.

But jumping into the market with a large sum of money without strategically thinking it through can cause you to suffer negative returns up to years at a time, and never recover as much as if you had invested slowly and regularly in a strategic manner.

Understand better the nature of each strategy and serve your clients well.

Source: Vanguard Studies:
Source: Money Maverick Official

1) https://personal.vanguard.com/pdf/s315.pdf

2) https://www.moneymaverickofficial.com/post/how-my-5-2-investment-completely-destroyed-another-s-6-5-by-almost-300-000

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