Reducing Your Risk With Dollar-Cost Averaging

Q. I keep reading about something called dollar-cost averaging. What exactly is it?

A. It's a technique in which you invest a fixed amount of money at regular intervals, regardless of whether the market is up or down. In a 401(k) plan you do this automatically, by contributing a set percentage of your salary from each paycheck.

Q. What's good about it?

A. Your contribution will always buy more shares when the price is low and fewer shares when the price is high. So your average cost per share will be less than the average share price during any given period. This is good because you're getting more shares for less money.

Q. Can you give me an example of how this works?

A. Sure. Let's say you invest $100 every month in XYZ stock fund. The first month, the price is $10 a share, so your contribution buys 10 shares. The second month, the price is $15, so your contribution buys 6.66 shares. Your $200 has bought a total of 16.66 shares. The average share price over the two months was $12.50. But because you bought more shares at $10 than you did at $15, your average cost per share was only $12.

Q. How does dollar-cost averaging affect my overall profit?

A. It increases long-term profit in an appreciating investment by lowering your average cost per share.

Q. Can dollar-cost averaging keep me from losing money even during a prolonged market slide?

A. No. But you'll lose less than if you'd made a single investment just before the market started falling. Dollar-cost averaging cushions your loss by lowering your average purchase price. For instance, if the share price in our example had fallen from $15 to $10, your 16.66 shares would be worth $166.60 - a $33.40 loss on your total $200 investment. On the other hand, if you had invested the entire $200 when the price was $15, you would have bought only 13.33 shares. When the price dropped to $10, your total investment would be worth $133.30 - a $66.70 loss. For all these reasons, dollar-cost averaging is an important method of managing and reducing investment risk in your retirement plan.

Dollar-cost averaging does not assure a profit and does not protect against market loss. This type of investment involves continuous investment in securities regardless of fluctuating price levels, so investors should consider their financial ability to continue their purchases through periods of both high and low price levels.

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A Drive Through The Stock Market

When you buy a stock, you become a partial owner of the company and entitled to a share of its distributed profits. People buy stock because they believe the value of their shares will increase in the future. If profits go up, share value usually goes up so someone is likely to pay a higher price for that stock and you can sell at a gain. If the company's profits don't go up, you probably would have to sell at a loss to get someone to buy the stock from you.

Say you decide to buy 100 shares of General Electric stock. Traditionally, you would place your order with a stockbroker, who forwards it to a trader working with that broker on the floor of the New York Stock Exchange (NYSE). The trader goes to the post where GE is traded. (Each of the 3,114 companies listed on the NYSE trades at a post.) There, a specialist (a person whose job is to match orders to buy with orders to sell) brings together the trader looking to buy GE stock with a trader looking to sell GE stock. The trade is completed at a price acceptable to both parties and you own 100 shares of GE.

Transactions like this happen thousands of times a day on the floor of the NYSE. Stock trading is still done face to face on major stock exchanges around the world, but an increasing amount is being done by computer. The Nasdaq Stock Market run by the National Association of Securities Dealers trades by computer. The NYSE is the world's biggest stock exchange, but Nasdaq, where many of today's hot high tech stocks trade, is a close second.

You may not own individual stocks, but instead invest in mutual funds that own stocks. The trade proceeds the same way, whether you or the manager of your mutual fund do the trading. The reason for buying or selling stocks is the same, too: both you and the mutual fund manager are hoping for the best possible return on your money.

Source: The New York Stock Exchange

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