What Is Dollar-Cost Averaging?

Every investor dreams of buying into the market at a low point, just before it hits an upswing, and garnering a large profit from selling at the market's peak. But trying to predict market highs and lows is a feat no one has ever fully mastered, despite the claims by some that they have just the right strategy that enables them to buy and sell at the most opportune times.

Attempting to predict which direction the market will go or investing merely on intuition can get you in trouble, or at the very least may cause you a great deal of frustration. One strategy that may help you navigate these investing pitfalls is dollar-cost averaging.

Dollar-cost averaging involves investing a set amount of money in an investment vehicle at regular intervals for an extended period of time, regardless of the price. Let's say you have $6,000 to invest. Instead of investing it all at once, you decide to use a dollar-cost averaging strategy and contribute $500 each month, regardless of share price, until your money is completely invested. You would end up purchasing more shares when prices are low and fewer shares when prices are high. For example, you might end up buying 20 shares when the price is low, but only 10 when the price is higher.

This strategy has the potential to reduce the risk of investing a large amount in a single investment when the cost per share is inflated. It may also help reduce the risk for an investor who tends to pull out of the market when it takes a dip, potentially causing an inopportune loss in profit.

The average cost per share may also be reduced, which has the possibility to help you gain better overall profits from the market. Utilizing a dollar-cost averaging program, the bottom line is that the average share price has the potential to be higher than your average share cost. This occurs because you purchased fewer shares when the stock was priced high and more shares when the price was low. Dollar-cost averaging can also help you to avoid the annoyance and stress of continually monitoring the market in an attempt to buy and sell at "fortuitous" moments.

Dollar-cost averaging is a long-range plan, as implied by the word "averaging." In other words, the technique's best use comes only after you've stuck with it for a while, despite any nerve-racking swings in the market. When other panicky investors are scrambling to get out of the market because it has declined and to get back into it when the market has risen, you'll keep investing a specific amount based on the interval you've set.

Dollar-cost averaging does not ensure a profit in rising markets or protect against a loss in declining markets. This type of investment program involves continuous investment in securities regardless of the fluctuating price levels of such securities. Investors should consider their financial ability to continue making purchases through periods of low and high price levels. The return and principal value of stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost.