DOLLAR COST AVERAGING PERFECTLY EXPLAINED SEPT 17, 2009

No. 8

Dollar-cost averaging is not rational, but it is pretty smart.

Suppose that you were wise or lucky enough to sell all your stocks at the top of the market in October 2007. Now what? Today it seems so clear that you should not have missed the opportunity to get back into the market in mid-March, but you missed that opportunity. Hindsight messes with your mind and regret adds its sting. Perhaps you should get back in. But what if the market falls below its March lows as soon as you get back in? Won't the sting of regret be even more painful?

Dollar-cost averaging is a good way to reduce regret—and make your head clearer for smart investing. Say you have $100,000 that you want to put back into stocks. Divide it into 10 pieces of $10,000 each and invest each on the first Monday of each of the next 10 months. You'll minimize regret. If the stock market declined as soon as you have invested the first $10,000 you'll take comfort in the $90,000 you have not invested yet. If the market increases you'll take comfort in the $10,000 you have invested. Moreover, the strict "first Monday" rule removes responsibility, mitigating further the pain of regret. You did not make the decision to invest $10,000 in the sixth month, just before the big crash. You only followed a rule. The money is lost, but your mind is almost intact.

Things could be a lot worse. ■

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