

DCA vs LS Investments

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Choose Between Dollar Cost Averaging and Lump-Sum Investing

Choosing between dollar cost averaging and lump-sum investing by evaluating your risk tolerance, your investment horizon and your ability to stick with an investing plan.

Lump-sum investing outperforms dollar cost averaging 75% of the time for stocks and 90% of the time for bonds, but dollar cost averaging may be a good choice for investors worried about taking on immediate risk, dollar cost averaging and lump-sum investing can both help you invest your money strategically, but it can be tricky to choose between them.

If your tolerance for risk is low, dollar cost averaging can help shield you from losses by spreading out your investments over time and through market fluctuations. If risk isn't your main concern, however, lump-sum investing can help you maximize your investment returns.

Here's a breakdown of how dollar cost averaging and lump-sum investing work and how to choose between them to meet your financial goals.

What Is Dollar Cost Averaging

Dollar cost averaging is the practice of investing equal amounts of money on a set schedule, regardless of market fluctuations. For example, automatically investing a portion of each pay-check into a retirement plan or setting up automatic deposits into an IRA are two common ways investors practice dollar cost averaging.

Another way an investor could use dollar cost averaging is to invest a windfall, such as a work bonus, tax refund or an inheritance. Rather than investing the money in one large transaction, the investor could space out their investments in equal amounts over the course of many months.

In practice, an investor could schedule multiple buy orders for a given asset over the course of a year. You might do this by setting up a buy order through a brokerage for \$100 in mutual fund shares each month, for example.

Pros of Dollar Cost Averaging

You're less exposed to timing risk. Timing risk is the risk of buying an asset for a certain price only to watch its value decline tomorrow. Dollar cost averaging mitigates this risk by spreading out investments, aiming to balance out your average price per share between higher and lower share prices.

It protects you from making impulsive decisions. One of the main benefits of dollar cost averaging is a psychological one: Investing gradually over time may help an investor feel less like they're betting all their chips at once by spreading out their investments. Investors sometimes make impulsive investing moves in the heat of the moment, which can easily lead to losses. Gradually investing according to a set schedule can help you maintain emotional distance from market fluctuations and avoid selling stocks at an inopportune time.

Cons of Dollar Cost Averaging

Opportunity risk may limit your gains. Holding off on investing can mean missing out on growth. For example, if the market rose 10% in a given year and you were investing a sum of money in incremental amounts, you would have only partially benefited from the growth. On the other hand, incremental investing also shelters you from loss when the market is in decline.

Dollar cost averaging requires discipline. Timing the market is risky and can lead to significant losses, so experts typically warn against this strategy. If you're planning to use dollar cost averaging to invest your money, it's important to stick with your investment plan regardless of market highs and lows to avoid falling into the trap of attempting to time the market.

What Is Lump-Sum Investing

There is no one best way to invest. If there was, we would all do exactly the same thing. Lump sum investing is a great choice for some situations, but it is not right for everyone in all situations. Lump-sum investing is investing a large sum of money all at once, rather than by making smaller investments over time. For example, using a windfall to buy many stock shares all at once is considered lump-sum investing.

Lump-sum investing can be most effective when done in combination with other smart investing moves. For example, funding an IRA or making a lump purchase of shares of a diversified fund are two ways to invest a large amount of money while limiting your exposure to risk. But remember that however you invest, you're taking on risk and should expect your account to fluctuate in value.

Lump-sum investing differs from dollar cost averaging in key ways. Here are the pros and cons of lump-sum investing.

Pros of Lump-Sum Investing

You're more likely to end up with higher returns. Lump-sum investing outperforms dollar cost averaging almost 75% of the time, according to data from Northwestern Mutual, regardless of asset allocation. If you're comfortable with risk, then investing your money in one large sum could yield better results. Of course, there's no way to predict future market performance, and past data doesn't guarantee future results.

You could see your investments pay off more quickly. In contrast to dollar cost averaging, lump-sum investing puts a large investment in the market at once. While this means more risk than holding some of your investment funds in cash, it also means more time to maximize returns.

Cons of Lump-Sum Investing

It requires a stomach for market volatility. Market fluctuations are a given, and you should expect your portfolio to gain and lose value regularly. But if you're not sure you'll be able to stand watching your balance rise and fall, investing slowly while you gain experience and confidence is a good way to start investing.

It's not a good alternative to investing on a regular cadence. Lump-sum investing is a good way to invest a windfall right away, but it's not a good ongoing strategy. Don't consider it an alternative to investing small amounts of money as you earn it, such as by deferring a portion of each paycheck into your retirement plan.

Understanding lump sum investing

Is all at once the right way to go? Often the only way to know for sure is hindsight.

With lump sum investing, all your money goes in on day one. If the market goes up from there, you'll be glad you got in early because any money you added after that would purchase shares at a higher price, giving you less bang for your buck.

On the other hand, if the market goes down from day one, your entire investment will go down as well, and you will have missed a lot of opportunities to buy in at a better price.

Of course, it's impossible to know how the markets will move from day to day or month to month. Individual results will always vary. And, if the market does go down immediately after you make a lump sum investment, there is sure to be some amount of regret. However, while we can't predict day-to-day movements, there is a century's worth of data showing that markets go up over time. The data suggests it's better to get in as soon as you can, making a lump sum a wise choice no matter what the markets do in the days afterward.

A 2021 report by Northwestern Mutual found that if you choose to make a lump sum investment instead of dollar-cost averaging, you are more likely to have a higher balance over time. The study looked at rolling 10-year returns on a \$1 million portfolio from 1950 until the present day, and lump sum came out better no matter whether an investor bought all stocks, a mix of stocks and bonds, or all bonds.

Our philosophy of investing would tend to agree. At The Motley Fool, we aim to find great stocks and hold them forever through ups and downs and avoid market timing. Delaying investing, or investing a large sum of money in increments over time, is a form of market timing. The better move is to get in all at once and ride the ups, along with the occasional downs, for as long as possible.

The longer you are invested in great, market-beating companies, the better your portfolio will do. And that means buying in as soon as possible. As the Wall Street adage goes, "Time in the market beats timing the market." Lump sum investing maximizes time in the market.

Invest With a Plan

Regardless of how you choose to invest your money, coming up with a plan can help you make smart investment decisions and avoid acting out of impulse. Investing with a goal in mind can help you be intentional in how much risk you take on.

Please don't hesitate to contact the support team by email (info@sainvestmentgroup.co.za) for any general or admin related enquiries that are not stipulated in the T&C's or FAQ.

Remember, "Time in the markets beats money in the market!"