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(Re) Entering the Market?

History suggests you jump in all at once. If that's too frightening, dollar cost average for, at most, 18 months. But understand the price you pay for going slowly

By Gregory D. Singer & Ted Mann

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The study of behavioral finance tells us that people's fear of financial loss exceeds their desire for gain. This helps explain why most people, given a sum of money to invest, prefer to enter the market in stages rather than all at once.

Based on the historical record, however, investing all at once is the better choice more often than not. The U.S. stock market has gone up more than 70 percent of the time during the last 80 years,[1] so the odds are in your favor that the market will outperform cash. By being fully invested from the start, you can enjoy all the potential gains.

But investing this way may be unnerving—especially after a year like 2008, when the memory of painful losses is fresh, stock market volatility remains high, and the economic future looks bleak. What if the market plunges again and your stake is abruptly diminished? Fearing this, many people hedge their bets and choose to enter the market slowly.

In fact, the practice of staged entry has been codified in a strategy known as dollar cost averaging, whereby you systematically invest a fixed amount of money into the market at regular intervals. This way, you get more shares of a stock when its price has dropped and fewer shares when its price has risen. Thanks to the popularity of automatic payroll deductions


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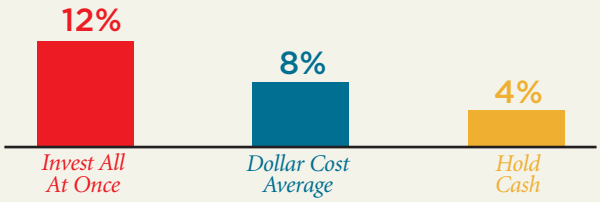
Decisive Action Pays

Investing in stocks with one lump sum tends to produce better returns than investing the same amount over time (dollar cost averaging)

Average One-Year Returns
In the U.S. Stock Market
From 1926 to 2008



Notes: Past performance is no guarantee of future results. Dollar cost averaging assumes level investments for 12 months. Results here are based on rolling 12-month U.S. stock market returns from 1926 through November 2008, represented by Ibbotson through 1974 and the S&P 500 thereafter.

Sources: Roger C. Ibbotson and Rex A. Sinquefeld, "Stocks, Bonds, Bills, and Inflation: Year-By-Year Historical Returns," *University of Chicago Press Journal of Business* (January 1976); Standard & Poor's; and AllianceBernstein

for retirement investing, millions of individuals practice dollar cost averaging. They also benefit from the enforced discipline of saving from every paycheck.

But there is a downside to dollar cost averaging: If the market rises while you are "averaging in," you miss out on potential gains. And those forgone gains could be substantial: Market rallies, especially coming out of bear markets, have often been rapid, with the bulk of gains occurring in a short time frame. Missing gains like that could have a substantial impact on your wealth if you are investing for the long term.

But how great an impact? Suppose you come into a windfall from a liquidity event such as an inheritance or the sale of a business. Should you hold it in cash and "average in" to the market, or should you invest it in one lump sum?

To quantify the tradeoffs involved, we compared the strategies in an historical analysis of the U.S. stock market since 1926, the point at which reliable data begin. This period encompasses about 1,000 different entry points across a wide range of market environments, from the Great Depression to the raging bull markets of the 1980s and 1990s to the worst of 2008.[2]

The results of our research provide practical guidelines for investors considering a move into the stock market. We found that investing all at once tends to result in more wealth over time. But for nervous investors, dollar cost averaging is a reasonable "insurance policy" against market risk—provided you don't overpay.

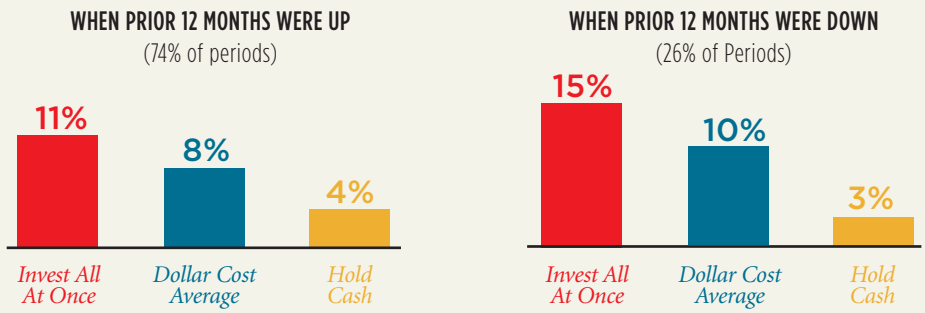
The Facts

Statistically speaking, investing all at once has been the best strategy for maximizing returns. The average gain of the stock market in all the rolling 12-month periods since 1926 was 12 percent. During the same periods, the average result of sitting on cash was just

Profit from the Bounce

If the market loses value in a 12-month period, history suggests it's likely to rebound in the next year

Average One-Year Returns
In the U.S. Stock Market
From 1926 to 2008



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4 percent. And, not surprisingly, the strategy of dollar cost averaging came in at the middle: 8 percent. That means that an investor who chose to make fixed monthly investments for a year would have, once fully invested, a portfolio worth about 4 percent less than someone who invested all at once at the start of the year. (See "Decisive Action Pays," on first page.)

It's important to note that the market's performance before each 12-month period had only a slight effect on this pattern. In fact, because of the tendency of the stock market to revert to its mean growth rate, the odds for a strong 12-month period improve if the market has lost ground in the previous 12 months.

Regardless of how one enters the stock market, the average one-year returns were much better in years following a negative 12-month period compared with a positive 12-month period. The strategy of investing all at once generated 11 percent average returns after a positive year, but 15 percent after a negative year. And dollar cost averaging chalked up 8 percent average returns after a positive year, but 10 percent after a negative year. (See "Profit from the Bounce," on previous page.)

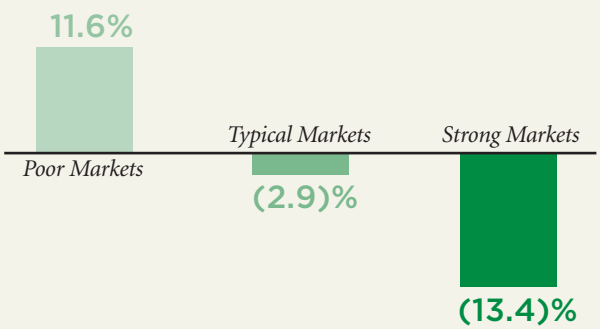
Holding cash—that is, not investing—did not come close to the returns of the stock market in either case, but was especially detrimental to returns after a negative year in the market. Remaining in cash yielded only 3 percent in the periods following a down year, 12 percentage points less than being fully invested. This reflects the fact that when the stock market recovers from a losing streak, it can rebound quickly.

But just because the statistics favor investing immediately doesn't make it the best strategy for all investors. There is a trade-off between the potential reward of stock market gains and the risk that the market might drop after you've invested. And everyone has a different tolerance for risk. So we developed a framework to help evaluate the trade-offs.

The Price of Going Slowly

Dollar cost averaging acts as a sort of insurance that protects wealth in poor markets. But if the markets are strong, that strategy can be costly

Additional Wealth After One Year Of Dollar Cost Averaging
In the U.S. Stock Market from 1926 to 2008



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Calculating the Costs and Benefits

Once again we analyzed stock market data for each 12-month rolling period since 1926, this time comparing the total wealth resulting from a strategy of investing all at once versus averaging in over 12 months. We also arrayed the 12-month periods by market performance, from the strongest to the weakest, in five quintiles. The bottom quintiles included markets as bad as those of 2008, while the top quintile included markets like 1954, when the S&P 500 rose 53 percent.

What we found is that in poor markets (the bottom quintile of performance), averaging in helped preserve capital, resulting in an average 11.6 percent more wealth than investing all at once. In typical markets (the middle quintile of performance), averaging in resulted in 2.9 percent less wealth. But in strong markets (the top quintile of performance), dollar cost averaging detracted significantly from returns: The average wealth after one year was 13.4 percent less than investing all at once. (See "The Price of Going Slowly," this page.)

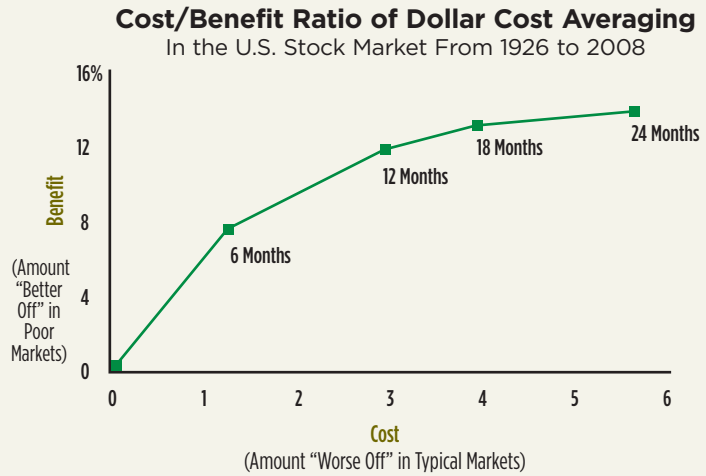
Note that these results are asymmetrical. The benefit

in poor markets is less than the cost in strong markets. Further, this cost has an enduring impact on an investor's long-term wealth: At the end of one year, both strategies will be fully invested, but the portfolio that used dollar cost averaging is more likely to be starting in a hole. If we take two portfolios that are identical—except for the fact that one was funded using dollar cost averaging and the other all at once—and track them side by side for 20 years, the portfolio that began with a 13.4 percent reduction from dollar cost averaging is always worth 13.4 percent less than the portfolio that began invested all at once.

Of course, dollar cost averaging also has a non-monetary value: It can help a nervous investor sleep at night. So a logical way to think of the strategy is as an insurance policy against stock market loss. But remember that the policy has a cost: In typical markets, it is 2.9 percent of one's holdings. You should ask whether that price suits you.

Cost Versus Benefit

How long you take to dollar cost average can make a big difference in the wealth you'll accumulate. Don't wait longer than 18 months



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Timing

Let's say that you're willing to pay the price of averaging into the stock market. The next question becomes: Is there an optimal period for doing so? A very nervous investor might want to ease in over years, while a more confident investor could be eager to move in several months.

We examined the cost and benefit of averaging in over different time periods, from six months to two years. We measured the cost as the amount of potential gain lost by averaging in during typical markets, and the benefit as the amount protected by averaging in during poor markets.

What we found is that, to a certain extent, the longer you take to average in, the higher the cost and the greater the potential benefit. (In effect, you are buying more insurance.) But if you extend the strategy too long, the benefit doesn't keep pace with the cost: Between zero and six months, there's roughly 7 percent protection for a cost of about 1 percent. Between six and 18 months, the trade-off between cost and benefit moderates, and after 18 months, there's little increased benefit for a much higher cost. (See "Cost Versus Benefit.)

Our conclusion: averaging in for a period of six months or less offers the best trade-off between cost and benefit. But for risk-averse investors who are willing to effectively pay an increased premium, one can extend the strategy as long as 18 months. Beyond 18 months, averaging in doesn't make financial sense (unless it's part of a program like payroll deduction, when the money only becomes available over time).

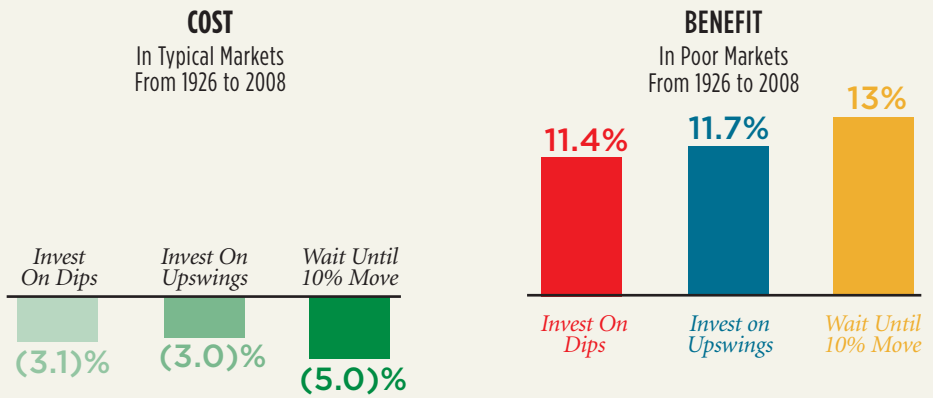
Better Ways?

Some investors are so scared of entering a falling market that they have tried to improve on the dollar cost averaging strategy with various tactics. For example, some watch market signals carefully to attempt investing before an upturn. Others invest only on market "dips." We analyzed these approaches to see if they boost results.

Using the same rolling 12-month periods, we modeled three strategies. In the first, we invested in six equal installments, investing each installment only after a down month—in order to invest on the dips. In the second strategy, we invested in six equal installments, again, only after an up month—to capture "momentum." And

Nice Try, But . . .

Three strategies that attempt to improve dollar cost averaging usually resulted in less wealth over time



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in the third strategy, we invested all at once after the market had moved up by 10 percent.

We found that, in typical markets, almost none of the strategies created an improvement over the simple strategy of level monthly investments. Only waiting for a 10 percent move off a trough showed a slight benefit, although its result of 13.0 percent greater wealth in poor markets was not much better than the 11.6 percent of regular monthly dollar cost averaging. But its cost in typical markets was high, 5 percent, compared with the cost of regular monthly dollar cost averaging, 2.9 percent. In essence, what these strategies do is extend the averaging-in period—in many cases over 12 months and longer—which, as we've already seen, is not cost-effective. (See "Nice Try, But...")

Strategies that prolong the market entry time period also open the door to another risk: if poor markets ensue, you will lose your nerve and stop investing altogether. The biggest risk to a staged investment plan is the temptation to second-guess the market and continue to wait in cash, which can lead to substantial erosion in long-term wealth.

Find Your Right Balance

Our research shows that if you have a sum of money to invest for the long term, entering the market all at once will usually prove to be a better strategy than dollar cost averaging. The odds are in your favor that you will reap greater wealth in the end.

But dollar cost averaging is reasonable insurance against the risk of investing in a falling market. If the market declines, your losses will be less than if you were fully invested. Of course, you have to be prepared that if the market does not decline, the cost of the insurance is likely to be a significant portion of your invested wealth.

When choosing to dollar cost average, a period of up to six months is the most efficient strategy; between six and 18 months offers a reasonable cost/benefit trade-off; periods over 18 months come at a high price.

Finally, if you decide to average in, it's essential that you choose a systematic method and time frame and stick to it. The alternative invites emotions to rule your investment decisions, which most likely will erode your wealth over the long term. TE

—Bernstein Global Wealth Management, a unit of AllianceBernstein L.P., does not offer tax, legal, or accounting advice. In considering this material, you should discuss your individual circumstances with professionals in those areas before making any decisions.

Endnotes

1. Every 12-month period since 1926, with each period beginning on the first trading day of each calendar month.
2. Data from Jan. 1, 1926, through Nov. 30, 2008.

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