DOLLAR-COST AVERAGING:
A SIMPLE AND PROVEN INVESTMENT STRATEGY FOR BUILDING WEALTH

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Introduction

Dollar-Cost Averaging (DCA) is a very simple investment strategy enabling regular investors to build worthwhile capital amounts over a period of time, normally of no less than five years. The idea is that the investor automatically allocates the same amount of money in a fund (or funds) at the same time every month.

The Basics of DCA

In our opinion, the underlying advantages of DCA far outweigh just about any other investment strategy (although regular allocations are required). Unless the underlying fund or asset class performs very poorly over a period of many years, the sheer power of the strategy appears undeniable. Its beauty is its simplicity: the same amount going in every month buys more units when the market is low (and most markets do not stay low for ever), and fewer units when it is high, and the mathematical effect of this over years can be very significant indeed. The longer the time period, the better tends to be the result.

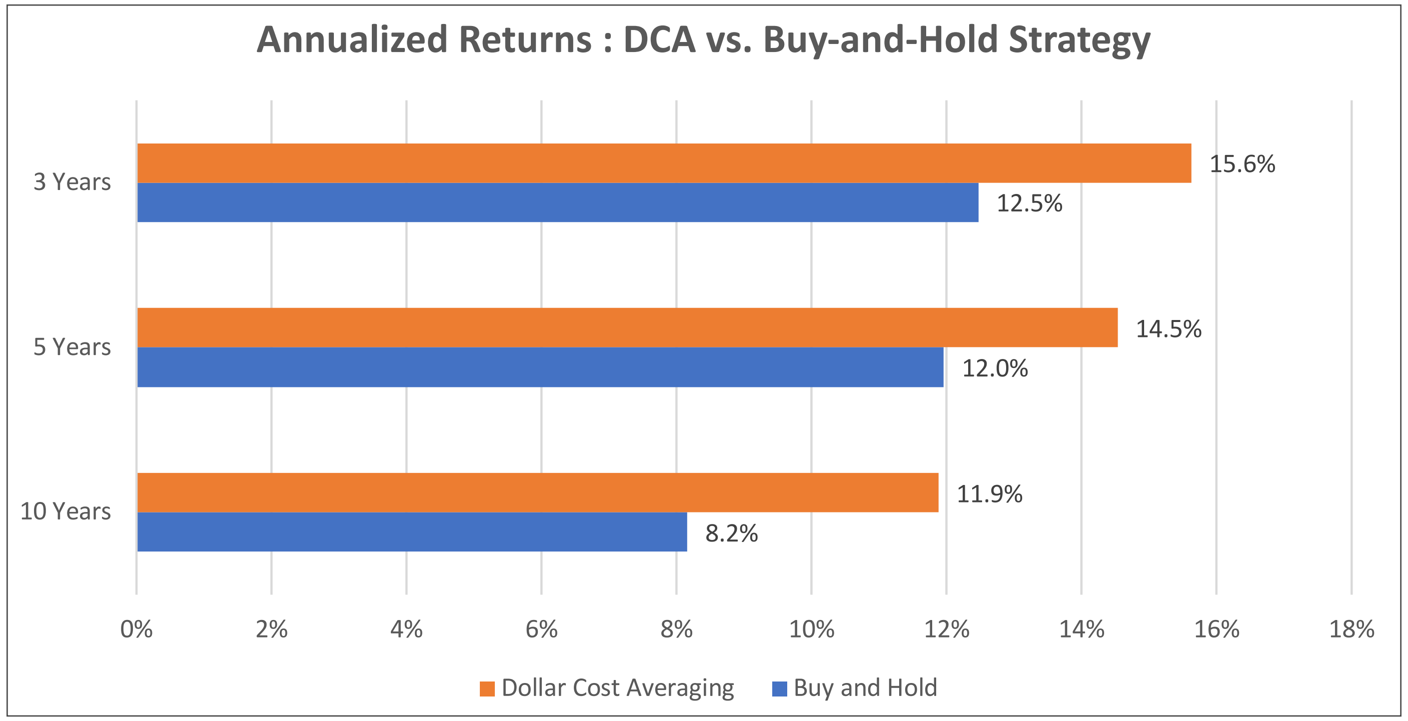
The application of DCA in reality - again unless the choice of asset class or manager is particularly poor - eliminates some of the significant challenges of investing. Regular investing in markets automatically imposes discipline on investors, who are fallible human beings who might believe they can satisfactorily deal with short-term uncertainties. Maybe sometimes they will, although often this could simply be luck.

Behavioural economists note that most investors are fundamentally loss-averse and tend to respond more harshly to losses, vs. the way they react to gains. However, by investing using a structured/interval technique such as DCA, one is far more likely to be investing smaller sums of money - in turn making it easier to stomach a poorly-timed investment. Another 'anchoring' bias is investors refusing to sell an investment they bought at or close to a high because they mistakenly believe it will exceed that value in the future.

Dollar-Cost Averaging vs. a Lump sum 'Buy-and-Hold' Strategy

We ran some tests using the S&P Pan Arab Composite Large Mid-Cap Index (SPACNUX), and found that DCA gave superior returns over a period of years, compared to a 'buy-and-hold' strategy. DCA gave an annualized return of 11.9% over ten years, compared to an 8.2% annualized return for a simple buy-and-hold strategy, therefore generating approximately a 3.7% superior annualized over the period – and arguably at a lower risk, given that drawdowns for the DCA were far less than for the buy-and-hold strategy. Similarly, over both three and five years DCA generated a superior annualized return compared to buy-and-hold. Please refer to the charts below:

Dollar Cost Averaging: Superior Returns



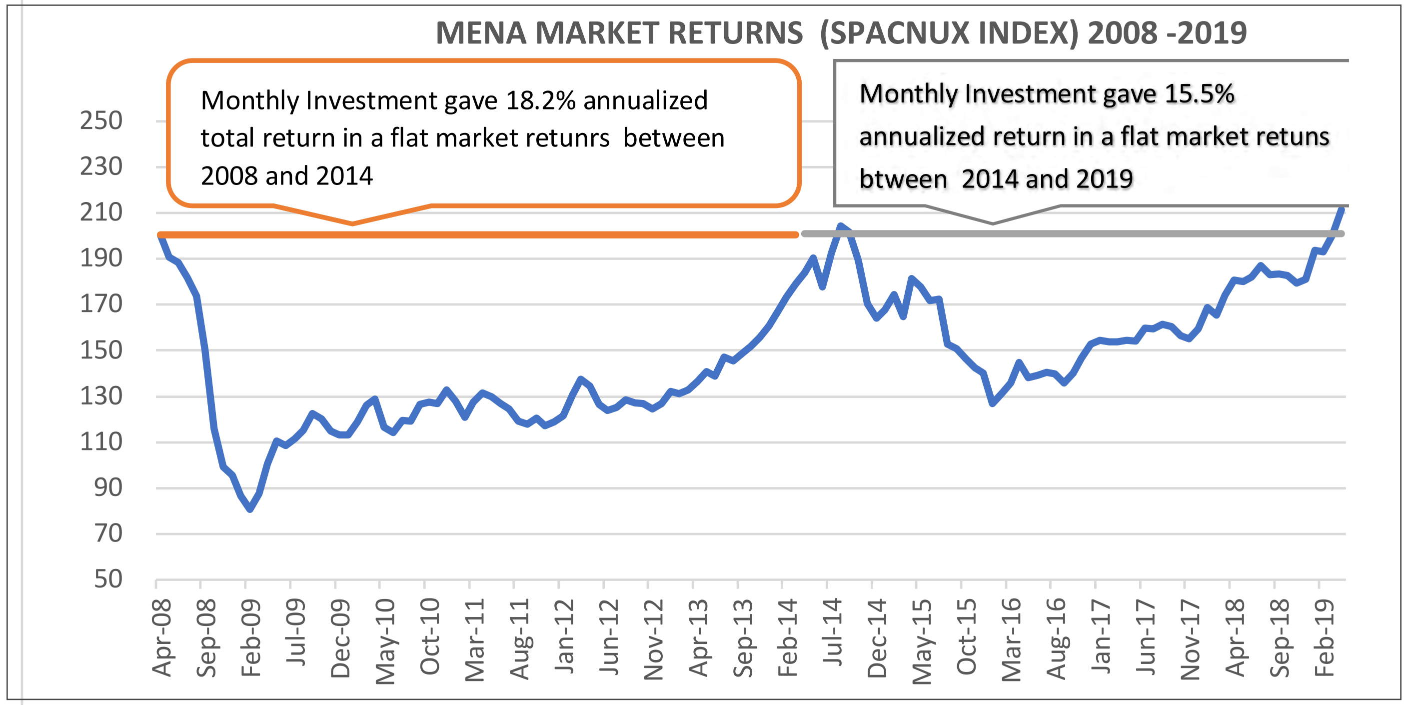
Source: Bloomberg/FAB

The Power of Dollar-Cost Averaging

By now the reader will have begun to see that diversification is actually not the only 'free lunch': DCA is the other one. Identical regular payments buy more 'units' when the market is low, and fewer when it is high.

Taking the analysis further, we looked at SPACNUX returns over the two flat market periods (between 2008 and 2019) detailed in the chart below. If markets are flat, how can investors make money unless via excellent stock and/or sector selection, or superb market timing? However the returns from DCA were an 18.2% annualized total return in the 2008-2014 period, and 15.5% during 2014-2019. This once again shows that the mathematical effect of DCA is probably one of the most overlooked ways to build wealth over time. DCA admittedly does require sufficient willingness and patience - and of course the ability to make regular uninterrupted payments.

Chart: The Power of Dollar-Cost Averaging in a Flat Market



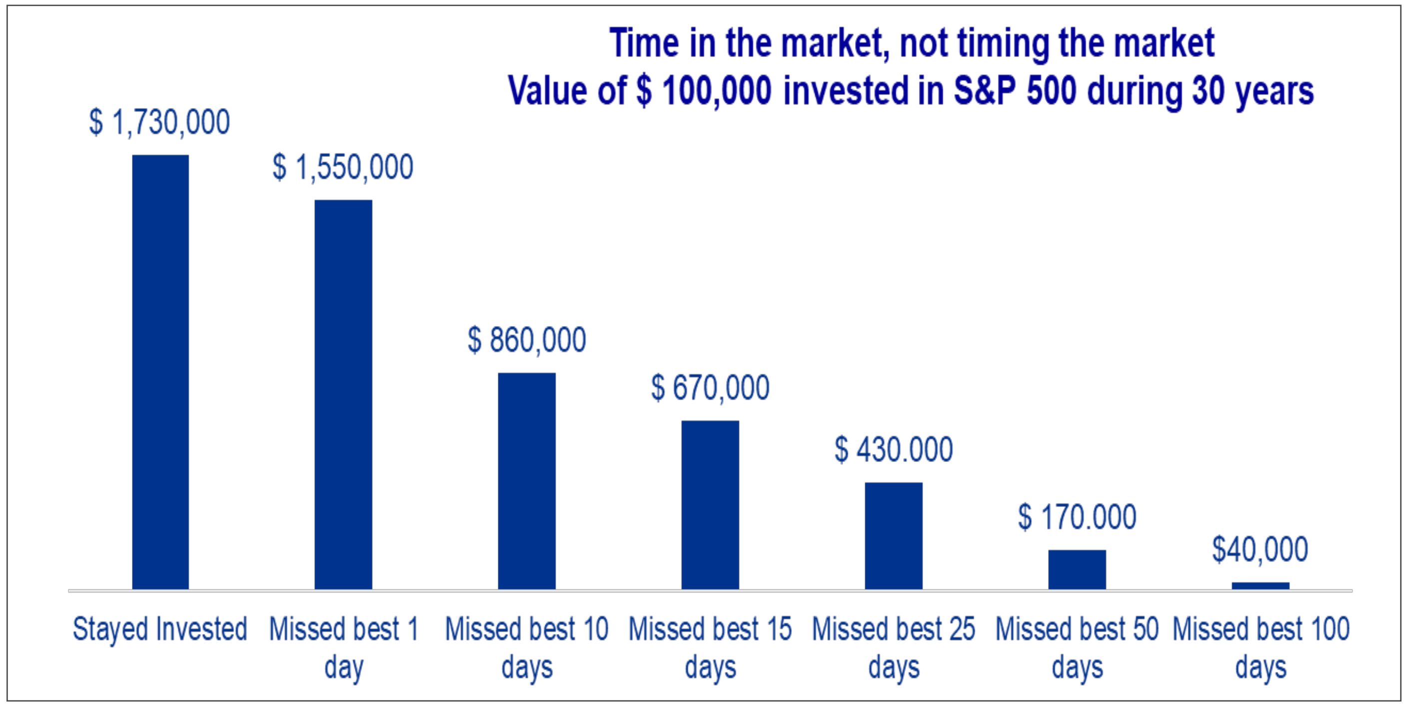
Source: Bloomberg/FAB

Being Fully Invested vs. Timing the Markets

Especially retail investors need to build capital over time, either for their retirement, to cover education fees, or for the proverbial rainy day. At the same time we understand that timing the markets can be very difficult, and some commentators say it is futile to attempt to do so. If one is in cash, there is always the risk of missing market recoveries, which can be quite explosive at times. In fact, simply staying invested has worked very well during the last 20 years, rather than attempting to time the equities markets. As discussed above, for regular savers/investors, DCA in many ways provides at the very least a partial solution. However, the 'automatic stabilizer' that we describe does also rely on practicing genuine diversification and periodic rebalancing between asset classes, as well as a genuine acceptance that investment should perhaps above all be a long-term endeavour. If a selection of DCA targets can be afforded, so much the better. FAB's private bankers and investment experts can help investors make those choices.

Similarly, engaging in market timing can force investors to attempt to predict the unpredictable. It could result in buying too late, or selling too early, with mis-steps in between. Academic studies have shown that missing just the 10 best days over the last 30 years could have reduced wealth by about 50%. As well as needing to get it right most of the time, timing must beat transaction costs. Market timing involves emotion - often causing investors to buy high and sell low.

Don't Try to Time the Markets



Source: Morningstar

Conclusions

By following a DCA investing strategy and committing to making regular monthly investments, an investor gets above-market returns over long periods of time - and at a much lower risk of drawdowns. DCA has worked very well in comparison to 'buy-and-hold', and usually vs. market timing. Perhaps crucial in all this is that DCA takes emotion largely out of the equation, and certainly over long periods and/or for particular asset classes. It may not suit every mandate, and it is best to have set long-term targets in mind.

We believe that DCA works well in all types of market cycles, and it is likely that only especially unfortunate asset or strategy choices would lead to poor returns. The mathematical power is such that investors can make good returns in even flat markets. If investors lack the time or ability to maximize returns, DCA in some form might provide a good part of the answer. Lastly, although we all want markets to rise in the years to come, and certainly when we need the money, imagine the beauty of not necessarily caring if the markets were flat or even lower for a while – or even for a few years.