Financial Planning

Revisiting Some Basic Investment Strategies

Dollar Cost Averaging

If a person were to invest the same fixed amount of money every week, month or year in a given stock or mutual fund over time, a phenomenal truth will soon become evident: The average cost per share will be less than the average price per share. Given the "normal" historical volatility of prices, i.e. their rise and fall in prices, that set dollar amount invested will buy more shares when the price is lower and fewer shares when the price is higher. If you are in the accumulation stage of life it is a good practice to set aside a certain percentage of your earnings regularly (weekly, monthly, quarterly, etc.). You can establish a periodic investment plan that would automatically buy shares of a stock or mutual fund on a regular basis – thus taking advantage of the benefit of Dollar Cost Averaging, i.e. buying more shares per dollar invested when prices are lower, and buying fewer shares per dollar invested when prices are higher. However, Dollar Cost Averaging does not assure a profit and does not protect against losses in a declining market.

Dividend Reinvestment Plans

Under such a plan distributed dividends would be used to buy additional shares of the same stock rather than be paid out as cash. Many brokerage companies have such plans for which they charge no commissions. The more shares you have, the more dividends you'll get. The more dividends you get, the more new shares you would buy. This process would continue and there would be ever more shares, paying out ever more dividends, purchasing ever more shares, etc. A sweet deal, especially at times like these when cash taken and deposited in savings or money market accounts are paying historically low rates on balances. A program such as dividend reinvestment is akin to dollar cost averaging and might make sense for long term investors looking to accumulate and grow their assets, or wealth. Keep in mind that not all companies pay dividends, as companies are under no obligation to do so.

Compounding

We've all heard the answer to the question "What would one penny, a single cent, be worth if it doubled every day for a month?" The answer is $5,368,709.12! And that is achieved through the miracle of compounding. Of course, there is no known investment that will double your money every day, but there is a simple formula for determining how long it would take to double your money at a given rate of return: The Rule of 72. The Rule of 72 simply states that if you know the annual percentage rate of return you can earn, that number divided into 72 will tell you how long it would take to double your money. For example, if you could earn 3% on a certificate of deposit, dividing that percentage, 3, into 72, gives the answer of 24 years. Conversely, if you had a given amount of money to invest and wanted to know what rate of return you would need to earn in order to double your investment in 10 years, you would simply divide the amount of money, for instance $10,000, into 72, and the answer is 7.2%. You should note that this rule of thumb does not consider the potential impact of taxes or inflation.

While none of these strategies can guarantee that you will make money as an investor, being aware of them could help you make more informed decisions on where, or how, to put your hard-earned savings or investment dollars to work. Also, remember that all investments are subject to risk, including the possible loss of principal. You should not construe this information as rendering tax or legal advice. Therefore, you should consult your tax advisor in order to understand the tax consequences of any product or service. ■

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