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How to Ride a Rocky Market

When markets are particularly volatile, many investors just want to sit on the sidelines.

It seems like a rational decision. Why put money into the stock market only to lose it amid the drumbeats of financial pundits who suggest that conditions can only get worse?

But investors with a long-term outlook shouldn't hide in fear. They can ride out the storm with a dollar-cost averaging investment strategy. Dollar-cost averaging is simply the practice of making regular, periodic and equal investments in a particular stock or stock fund over a sustained period of time, instead of investing a lump sum all at once. This strategy protects you from the risk of having to time the market, and it can also take the emotional stress out of building a portfolio, says Jonathan Satovsky, chief executive of Satovsky Asset Management in New York.

The biggest mistakes made by individual clients come from their fear of losses in a down market and fear of not being invested fully in a bull market, says Satovsky. "These emotions consistently cause poor timing and judgment in investment portfolios."

AVOIDING SHORT-TERMITIS

Making regular purchases of a security over time, particularly in a volatile market, reduces an investor's average cost for that particular asset. When shares are up, the investor buys fewer shares; when the per-share price falls, that same amount of money purchases more

units. A fixed amount of money might buy 20 shares when the market is low and only 10 when the market is high.

However, no one can guarantee that dollar-cost averaging provides higher returns than simply investing a lump sum. When they reviewed 65 years of data (1926 to 1991), Wright State University business professors Richard Williams and Peter Bacon found that while dollar-cost averaging does reduce the risk of an investor entering the market when stocks are overpriced, it doesn't necessarily produce superior total returns to a lump sum investment.

But that potential sacrifice is a fair trade-off for the reduced risk, Satovsky says. Plus, a steady plan can alleviate the all-too-human impulse to make choices based on short-term thinking. "The short-termitis disease afflicts most investors, and the pain of seeing daily and monthly balances fluctuate wildly can lead to bad decisions," says Satovsky. "Money from retail investors flows in the opposite direction from where you'll find the greatest long-term opportunities." More simply, investors are prone to either panic or excitement, depending on the market's course.

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STICKING TO THE STRATEGY

Michael J. Mauboussin, the chief investment strategist at Legg Mason and author of a book on behavioral finance, *More Than You Know: Finding Financial Wisdom in Unconventional Places*, says that such reactions to immediate downturns are innate. “Losing money in the stock market affects the same part of the brain that reacts to truly distasteful things such as vomiting.”

Sticking to a preset dollar-cost averaging strategy removes the emotional and biological stumbling blocks that can afflict investors during down cycles in the stock market and, over time, can give investors a decent shot at duplicating the market’s historic 10% rate of return.

Of course, some people don’t have a choice but to dollar-cost average. A lump sum might be an option for investors who receive a large bonus payment, inheritance or proceeds from a real estate sale, but since most are people investing from salaries paid

every two weeks, dollar-cost averaging is a convenience. And company 401(k) plans implement a dollar-cost averaging strategy by design with regular pretax contributions pulled from an employee’s paycheck. Most IRAs, mutual funds and brokerage accounts can be set up to do the same thing, with automatic withdrawals and investments.

Of course, investors shouldn’t confuse dollar-cost averaging with a “set it and forget it” approach. Portfolios still need to be rebalanced at least annually; changes in a mutual fund or in the company whose stock you are buying need to be taken into account when those events happen. Diversification is still essential. The point is to invest consistently, not blindly, and to avoid the perils of taking your investment cues from the daily market gyrations ■

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Michael J. Mauboussin, Chief Investment Strategist at Legg Mason

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