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Dollar-cost averaging for investors

THE INFORMED INVESTOR
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Against the backdrop of recent market volatility and record inflation, we are seeing renewed interest in an investment strategy known as "dollar-cost averaging."

Nearly fifty years after the publication of his seminal work titled *A Random Walk Down Wall Street*, Burton Malkiel continues to encourage investors to consider dollar-cost averaging as a hedge against inflation. While he acknowledges that the strategy is controversial, he contends that it can help investors avoid the risk of putting all their money in the stock or bond market at the wrong time. In an opinion piece published in *The Wall Street Journal* in September, Malkiel cautions investors against giving up on equities.

He takes the position that long-term investors saving to build a retirement nest egg need to invest in a portfolio heavily weighted with common stocks because stocks have been an "effective hedge against inflation for more than a century and are likely to be so in the future." In this column we consider the pros and cons of using dollar cost averaging as an investment strategy and we provide two scenarios that illustrate how the strategy might be applied.

WHAT IS DOLLAR-COST AVERAGING?

Dollar-Cost averaging is a method of investing a fixed amount of dollars in securities at predetermined intervals. The basic premise is that the dollars invested will buy more shares when the price is low and fewer shares when the price is high. While the desired outcome is that the overall cost of the shares purchased would be lower than it would be if a fixed number of shares were bought at set intervals, investors cannot assume that a lower overall acquisition cost will result if they implement the strategy.

This method is sometimes referred to as a "constant dollar plan" because the dollar amount invested remains constant. Malkiel says that "dollar-cost averaging makes it possible for investors to gain positive returns even when market averages don't increase…and the greater the volatility of stocks prices, the greater the potential of gain" – a hypothesis that will be tested repeatedly.

DIVIDEND REINVESTMENT PLANS

A dividend reinvestment plan is a program that allows investors to reinvest their cash dividends in additional full or fractional shares of the underlying stock on the dividend payment date. Many publicly traded corporations offer these programs to existing shareholders. Most equity mutual funds offer an automatic dividend reinvestment option for shareholders. Mutual fund shareholders who elect to reinvest dividends typically do not incur a sales charge in connection with the additional full or fractional shares purchased.

The shares acquired are customarily purchased at the net asset value of the fund calculated on the dividend payment date. The dividend reinvestment option allows shareholders to accumulate capital over the long-term using dollar-cost averaging. Investors can find relevant information about dividend reinvestment programs in the fund prospectus.

TRADING PLANS FOR CORPORATE INSIDERS

Company stock and options to purchase company stock are fairly typical components of executive compensation in the public company sector. However, exposure to material non-public information about the company (MNPI) can pose challenges for corporate insiders, typically executive officers and directors, who seek to purchase or sell shares. Twenty-two years ago, the Securities and Exchange Commission (SEC) adopted a rule that made it easier for public companies and their insiders to effect transactions in company stock.

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Federal anti-fraud laws and rules prohibit the use of manipulative and deceptive devices in connection with the purchase or sale of securities. Rule 10b5-1, adopted in 2000, acknowledges that the manipulative and deceptive devices prohibited under these anti-fraud provisions include purchases and sales of securities made "on the basis of" MNPI about a security or issuer in breach of a duty of trust or confidence that is owed to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of that MNPI.

The rule also specifies that a purchase or sale of a security is made "on the basis of" MNPI when the person making the sale or purchase was "aware" of MNPI at the time the purchase or sale was made. In other words, possession of MNPI when the person trades, rather than actual use of MNPI in connection with the trade, will be sufficient to establish a violation of the anti-fraud provisions of the federal securities laws under Rule 10b5-1.

The incorporation of the broader "possession" standard in the rule is significant because many corporate insiders are likely to be in frequent possession of MNPI. However, Rule 10b5-1 also provides an affirmative defense for corporate insiders who have established a "trading plan" in accordance with the requirements of the rule at a time when the trader was not aware of MNPI.

These trading plans effectively provide a safe harbor that allows executives, who are frequently in possession of MNPI, to lawfully trade company stock by passively making prescheduled trades, typically with the assistance of a broker who has no flexibility to modify the original trading plan. The affirmative defense against allegations of insider trading will be available to an insider only if a Rule 10b5-1 Trading Plan was established in good faith at a time when the insider is not in possession of MNPI. The trading plan must be in writing and must meet other requirements of the rule.

Most public companies adopt and implement policies and procedures reasonably designed to detect and prevent insider trading. Rule 10b-5 trading plans are customarily designed to take those policies and procedures into account.

Note that, in the case of a trading plan designed to accumulate capital, the dollar-cost averaging strategy will be available only when the price at which shares of a company will be acquired is a "market price" rather than a "limit price." It is important to note, too, that Rule 10b5-1 does not supplant other federal securities laws and rules that must be considered by corporate insiders.

These trading plans have been under increasing regulatory scrutiny. Late last year the SEC proposed changes to the Rule 10b5-1. As then-Commissioner Allison Herren Lee stated, the proposed rule amendments were necessary to ensure that the rule offers a "safe harbor, not a pirates' cove."

ADDITIONAL THOUGHTS

There are certainly many arrangements that permit disciplined investors to commit a specified amount of capital to an investment program through payroll deduction or otherwise. There is no uniform consensus that a dollar-cost averaging strategy is an appropriate strategy for all investors. In fact, the strategy can work against investors when they convert equities back into cash.

As one astute investor put it, when calculating returns from a movement between asset classes, it is important to complete the round trip before drawing conclusions. Investors should consult with their financial advisors as to the advisability of dollar-cost averaging, taking into account their investment goals, investment time horizon, risk tolerance and other relevant factors.

Patricia Foster is a securities law attorney with Harris Beach PLLC. Her experience includes representation of clients in both registered and exempt securities offerings. She also has experience in various sectors of the financial services industry, including broker-dealers, investment advisers and investment companies. This column is a collaborative work by Patricia Foster and David Peartree. David Peartree is an adviser with Brighton Securities Capital Management, Inc., a registered investment adviser offering fee-only investment and financial planning advice. The information in this column is provided for educational purposes and does not constitute legal or investment advice.