You've Received an Influx of Cash. Is It Best to Invest It as a Lump Sum or by Dollar-Cost Averaging?

As the legendary financier Bernard M. Baruch once said, "now is always the hardest time to invest." This is especially true for families who receive an influx of cash after selling their business or because of some other once-in-a-lifetime event. With the stakes so high, determining how to invest that money can be harrowing.

Since we founded our firm 18 years ago, we've helped families invest billions of dollars that they've received from exiting businesses. We and our clients have found that it's always challenging to invest sizeable amounts of cash. So, what's the best way to do it?

There are two main approaches to investing cash: dollar-cost averaging and lump-sum investing.

Dollar-cost averaging means investing cash over time so you can reduce the effects of the market's volatility and spread the risk. A common way to dollar-cost average is to pick a specific period, such as a year, and invest an equal amount of money at the end of each month or quarter throughout that year.

Lump-sum investing means what it sounds like: investing all the cash at once.

Lump-Sum Investing Earns More on Average

If you look at the statistics, the best approach appears to be lump-sum investing. For example, a Vanguard research report concluded that those who opt to lump-sum invest end up with more money two-thirds of the time. This makes intuitive sense because the market is up about two out of three calendar years on average. So, spreading your investments out over time is usually sub-optimal.

In the Vanguard report, the authors briefly address the emotional and psychological aspects of investing and acknowledge how hard it is to lump-sum invest. But they also make a strong case for investors to set aside their emotions and invest all at once. And they're not alone in reaching this conclusion. Research from Invesco, Gerstein Fisher, and others also concludes that investors that pursue lump-sum investing will receive better returns on average.

But You Still Might Prefer to Dollar-Cost Average

I agree, on average, that investors will make more money if they invest their cash as a lump-sum. But what applies to "all investors on average" doesn't necessarily mean it will generate the best outcome in your situation.

That's because the probabilities that apply to entire populations aren't as applicable to individual events.

A good example of this anomaly is a story from the 1960s when Nobel Prize-winning economist Paul Samuelson asked his lunch partner in the MIT cafeteria if he'd accept a wager in which the colleague would win $100 on a coin flip if it was heads and lose $50 if it was tails. This seems like a great bet because it has an expected return of $25. But Samuelson's colleague refused the bet, saying he'd only wager if Samuelson would repeat the bet 100 times. The MIT colleague's response was brilliant. The wager's expected value might have been $25, but there was also a 50-50 chance that he'd lose $50 if he only wagered once. So, if $50 is more loss than you can stomach, you should decline to play just once even if the expected return is positive. In this case, your chances of making money on the bet improve the more times you play.

Another example of how probability doesn't always work out in a person's favor in a one-time event comes from early 20th-century economist George Shackle. In the book Radical Uncertainty by John Kay and Mervyn, the authors cite a story that Shackle tells of a palace guard pondering whether to join the revolution, "knowing that he faces likely death if he discharges his duty and the revolution succeeds, but that he will also die if he joins the insurgents and the coup fails. But to defend the palace and see the coup fail may give rise to large rewards." In this case, Shackle notes, "Knowledge of the frequency of successful revolutions is of little help. Only this revolution matters."

These examples are analogous to a family investing a once-in-a-lifetime influx of cash. How hypothetical investors fare on average with lump-sum investing is no comfort to the family that invests its hard-earned cash just before the market crashes. For most of the families I've worked with, it has been more comfortable for them to invest the money over time and understand that they'll have a two-thirds chance of not doing as well as if they'd invested it all at once.

It is paramount that the investor who chooses to dollar-cost average realizes that their choice to spread out the risk will likely cost them money and to make peace with that fact at the outset. They are choosing a probable lower return in exchange for a lower risk of loss.

How to Dollar-Cost Average Effectively

Now is indeed the hardest time to invest. The market always seems uncertain, but that's especially true recently. It has either been falling and appears likely to fall more, or it's been rising and seems due to pull back, making investing now feel like too late.
If you aren't going to lump-sum invest, it is imperative to have a disciplined, calendar-based dollar-cost averaging plan and stick with it. For example, a plan would be to invest 25% of the lump sum on May 1, 25% on August 1, 25% on November 1, and 25% on February 1. Then do it no matter what is going on in the markets.

Another strategy that works, but is often harder to follow, is to invest when the market goes up or down by a certain percentage. For example, you can invest 25% of the lump sum when the market falls 5% or rises 5% (and so on). If it declines, then you are investing at a lower point. If it rises, you trigger a purchase before it becomes emotionally too difficult to purchase at even higher levels.

The answer to how to best invest an influx of cash is that there is no best way – it depends on individual circumstances and risk tolerance. What is most important is that the investor understands the trade-off between dollar-cost averaging and lump-sum investing. The investor who decides to dollar-cost average is choosing a probable lower return in exchange for a lower risk of loss. In any case, don't let the fear of the unknown cause you to just sit on the cash. That is easily the worst option – on average, of course.