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ARTICLES

Dollar-Cost Averaging and Prospect Theory Investors: An Explanation for a Popular Investment Strategy

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Keywords

Dollar-cost averaging	Lump sum investing	Behavioral finance	Prospect theory	Monte Carlo simulation
Bootstrap simulation				

Notes

1. Fisher and Statman [1999] use a similar framework to analyze time diversification.

2. See Statman [1995], p. 74.

3. See Tversky and Kahneman [1992], p. 298.

4. As an example, Statman [1995] discusses defined-contribution pension plans, such as 401(k)s, where employees do not have an explicit choice between a lump sum investment and a dollar-cost averaging investment. See Statman [1995], p. 76.

5. Therefore, the results of Frühwirth and Mikula [2008] are not surprising. They compare a 10-year lump sum investment with a 10-year dollar-cost averaging strategy based on yearly payments. With a high equity risk premium, one would expect that the lump sum strategy dominates the dollar-cost averaging strategy over this long time



11. See Dimson et al. [2006], p. 29; Dimson et al. [2002], p. 19.

12. Abeysekera and Rosenbloom [2000] also base their simulations on a 20% annual stock market volatility.

13. See Dimson et al. [2006]. They document a high volatility around 30% p.a. in the German, Italian, and Japanese stock markets over a long period of time (1900–2005).

14. There may be other reference points, for example, the return target derived within an asset-liability analysis for a specific investor. However, such a reference point is highly investor-specific, and the results cannot be generalized. Furthermore, as other studies also use the zero return and the risk-free rate as reference points (e.g., Hens and Bachmann [2008]), we believe that this is a representative choice for our study.

15. For simplification, we implemented a statistical test only for cumulative prospect values.

16. The parameters recommended in Abdellaoui et al. [2005] are also used in the study of Breuer and Perst [2007].

17. The risk-free rates are average values from the Frankfurt money market.

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18. As we simulate continuously compounded monthly returns with the geometric

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