POWER OF COMPOUNDING

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Compounding: The Little Secret To Wealth Creation That Young Investors Must Never Ignore

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Compound Interest is the eighth wonder of the world. He who understands it earns it. He who does not pays it. – Albert Einstein

We all have heard the above quote & the fact that money makes more money. But have you ever wondered, what made a genius of all time like Mr. Albert Einstein to say that compounding is the eighth wonder of the world? How to implement compounding in financial life to create solid long-term wealth?

This post will cover the way compounding works & some easy tips on how to apply it in your financial life. We'll also share a case study that will help you understand why this hidden secret to wealth is the key to unlocking wealth creation. Sounds interesting? Let's begin…

What is compounding & how does it work?

Compounding is a process by which you do not withdraw the interest that you earn on the money. That interest then joins the principal & earns higher interest. And this sort of builds a chain reaction. Let us understand with the help of an example.
You have INR 10,000 & you invest in a scheme that gives a return of 10%. At the end of year 1, your interest is INR 1,000. Now, instead of withdrawing this interest, you let it remain invested.

At the start of year 2, your investment is INR 11,000 (Original principal amount INR 10,000 + Interest of Year 1 INR 1,000). The interest in Year 2 is INR 1,100 (INR 11,000 * 10%).

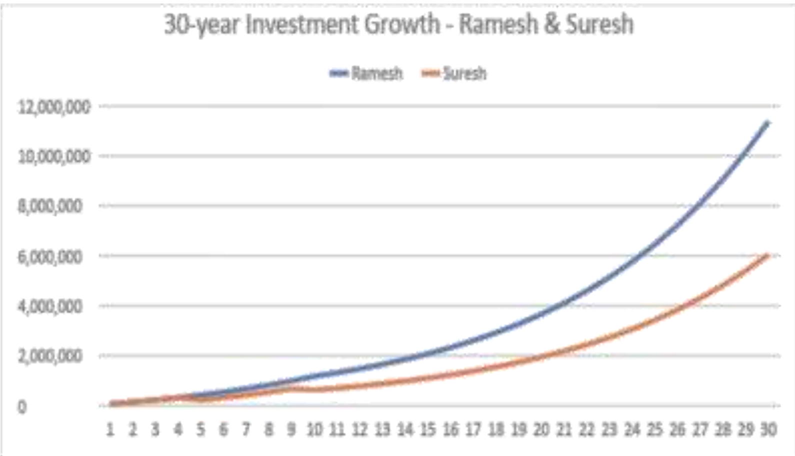
Had you withdrawn the interest at the end of Year 1, the Year 2 interest would have been INR 1,000 only. So, due to compounding, you get a net benefit of INR 100.

In mathematical terms, the formula for compound interest is: **P [(1 + i) n – 1]**
P = principal, i = annual interest rate in percentage terms, n = number of compounding periods

Case Study on how compounding can make a difference in your long-term wealth corpus:

Let me explain the power of compounding with the help of a case study.
Ramesh & Suresh invested INR 5,000 per month in mutual funds every year for the next 10 years. Let us assume that the return from the mutual fund over the next 30-year period was 12%.
Ramesh did not withdraw the money in the 30 years & let the money remain in the markets to grow. However, Suresh withdrew twice, INR 5 lac in year 5 for some home renovation & and another INR 5 lac in year 10 for an exotic trip to Mauritius.

Now, let us see how the investments of Ramesh & Suresh fared in the 30 years.



While Suresh's portfolio value at the end of 30 years stood at INR 60.46 lacs, Ramesh's portfolio value stood at a WHOOPING INR 1.14 crores – 90% more wealth than Suresh!!

This means that by withdrawing a mere INR 4 lacs in the initial years & thereby interrupting compounding twice, Suresh lost a staggering INR 53.29 lacs in investment value over 30 years. I hope this case study helps you understand the importance of compounding and why a genius like Albert Einstein called it the world's eighth wonder.

6 simple tips on how you can benefit from compounding

Now that you know the secret of compounding, we share some tips that can help you better apply it in your financial life.

Tip #1: Start early and as early as your first salary. The earlier you start, the more time you have on hand to let compounding work for you. So, do not waste your initial years – start investing every month, even if it is a small amount. And let it grow over time.

Tip #2: Resist the temptation to withdraw the money for any splurges etc. It is also a good idea to create a separate splurge fund & use it to fund your impulsive purchases. Another idea is to plan for your expensive purchases in advance. This will also save you from the trap of personal loans & credit cards.

Tip #3: Invest some portion of your money in long lock-in investments like PPF (15 years) and NPS (money locked till 60 years of age). Investing in such avenues will give you an additional tax benefit and help in "forced" compounding to create a solid wealth corpus in the long run.

Tip #4: Earmark all your investments to financial goals like a child's education or retirement. Knowing that this saving is for a financial goal, you will resist withdrawing the money.

Tip #5: Live a sensible and straightforward lifestyle as much as possible. Limit yourself to simple hobbies, carefully choose your social network & try to be mindful of financial implications while making purchase decisions.

Tip #6: Stay away from getting rich quick ways of making money, hot stock tips, dabbling in Futures and Options, bitcoins, forex trading, real estate investments etc. They have the potential to destroy all your reasonable effort in saving & investing.

Conclusion:

Compounding is a hidden secret of wealth creation that can make or break your financial life. The more you let your money remain in the market and grow, the more you let the power of compounding work for you. Start early, invest regularly and don't withdraw the money unless needed. This can go a long way in helping you create a substantial corpus and secure your financial future.