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INVESTMENT MANAGEMENT

National savings month: mastering compound interest: everyone's financial superpower

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As we enter the final week of National Savings Month, it's an opportune time to highlight the power of compound interest, a cornerstone of long-term financial growth. Warren Buffett famously described compound interest as the "eighth wonder of the world." His wealth, largely accumulated after his 50th birthday, underscores the transformative power of time and patience in investing. The secret? Start early, invest consistently, and allow compound interest to work over time. As Buffett himself noted, "My life has been a product of compound interest."

Theodore Johnson's journey illustrates the power of compound interest. Starting with the United Parcel Service in 1924, Johnson never earned more than $14,000 annually. However, he implemented a simple but effective strategy: setting aside 20% of his pay check and Christmas bonuses to purchase UPS shares. Consistently investing a portion of his income, Johnson capitalised on the magic of compounding. Over time, his investment grew significantly, reaching a value of over $70 million by age 90.

So, what is compound interest?

It occurs when the interest you earn on your principal is reinvested, allowing you to earn interest on the new total. This "interest on interest" creates a snowball effect, significantly increasing your investment's value over time.

For example, if you invest R10,000 at a 10% annual return, you'll have R11,000 after the first year. This R1,000 gain is simple interest. However, if you reinvest the interest, the next year's calculation will be on R11,000, leading to a greater total. After two years, your investment grows to R12,100, thanks to the power of compounding.

The power of compounding becomes more significant with larger amounts. For instance, a 10% return on R10,000 is R1,000, but the same percentage on R100,000 yields R10,000. The more you invest, the greater the impact of compound interest.

Consider this: if Investor A invests R2,000 per month from age 25 for 40 years at a 10% annual return, the investment grows to R12,879,287.82. Notably, the investment earns R1,194,844.35 in the final year alone, demonstrating the exponential growth compounding provides. As Charlie Munger advised, "The first rule of compounding: Never interrupt it unnecessarily."

Starting early is crucial

Comparing two investors highlights this: Investor A, who saves R2,000 monthly from age 25 for 10 years, ends up with R12,879,287.82 by age 65. Meanwhile, Investor B, who starts saving at age 35 and saves for 30 years, ends up with R4,803,306.42. Despite contributing more in total, Investor B's later start results in a smaller final amount, illustrating the advantage of starting early.

Why don't more people harness compound interest?

Many fail to do so due to a lack of planning, often withdrawing investments prematurely for emergencies or other needs. Additionally, debt mismanagement can negate the benefits of compound interest, as it also works against you by compounding debt. Impatience and reacting to short-term market fluctuations can disrupt the compounding process, leading to suboptimal returns.

Compound Interest Tips:

1. **Start Early**: The earlier you start investing, the more time your money has to grow.
2. **Be Consistent**: Regular contributions to your investment can significantly enhance the compounding effect.
3. **Reinvest Earnings**: Ensure that any interest or dividends earned are reinvested to maximize growth.
4. **Avoid Unnecessary Withdrawals**: Keep your investments intact to benefit fully from compounding.
5. **Pay Off Debt**: Manage and reduce debt, as interest on debt compounds just like investment interest, but works against you.

Harnessing the power of compound interest is straightforward yet requires discipline. By eliminating debt, starting to invest early, and remaining invested for the long term, you can maximize the benefits of compounding. This National Savings Month, commit to understanding and leveraging compound interest to secure your financial future.

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