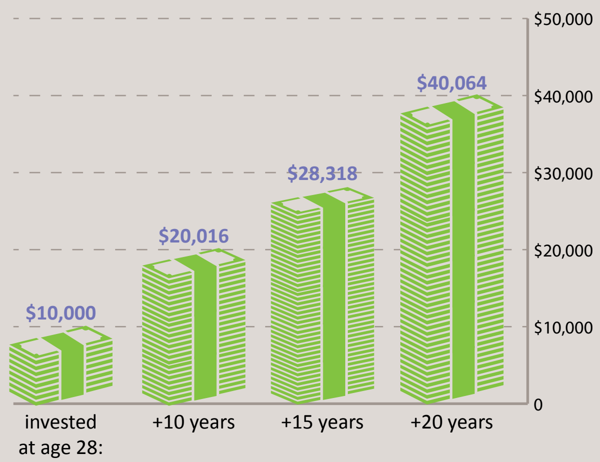
The power of compounding

Compounding is often referred to as “magical” because of the way it can help your savings grow. However, while its power is impressive, the way it helps you is simple math, not magic.

Compounding simply refers to producing earnings off of your previous earnings. Each time your earnings are “compounded,” it means that the amount you have earned on your original investment (usually in the form of interest or dividends) has been added to your original investment, increasing both the principal and the amount that your principal can earn on its next earnings payment.

Depending on the investment, compounding can occur at various frequencies (e.g. daily, monthly, quarterly or annually). When all other factors are equal, generally the more often you compound, the higher your earnings will be. The reason compounding gets so much fanfare (Albert Einstein reportedly called it “the eighth wonder of the world”) is that it can offer you exponentially increased earnings with minimal effort on your part.

Compounded quarterly, earning an average rate of 7%



Consider this example to see how your money can grow through compounding. Say you invest $10,000 at age 28, with your investments compounded quarterly and earning an average rate of 7 percent. After 10 years, this account would be worth $20,016 — more than twice its original balance. After 15 years, that number jumps to $28,318, and after 20 years, your original investment would more than quadruple and be worth $40,064. The exponential growth compounding creates is the reason it has so much power in the financial world.

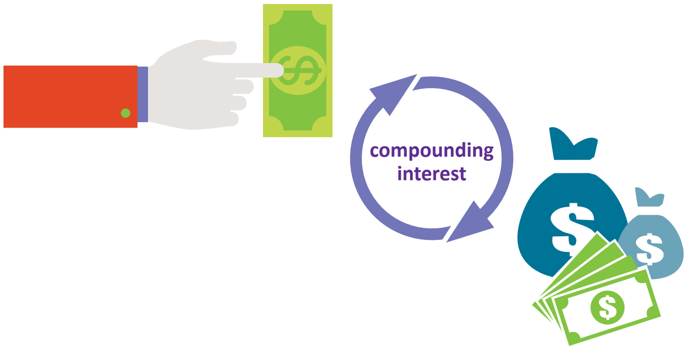
Compounding and retirement

Compounding can help you increase your net earnings no matter how you save, be it in a regular savings account, a retirement plan or a taxable investment account. However, using compounding for your retirement savings is especially important because your retirement is likely to be one of your largest expenses, so you want to see your earnings grow as much as possible. Using a qualified retirement plan makes your earnings from compounding even more effective because your earnings can grow either tax-deferred or tax-free. While taxes chip growth away when your portfolio is in a taxable account, retirement accounts allow your investments to grow until you withdraw.

Start early

If you are just starting to earn an income or have just opened your first retirement account, retirement can seem like a far-off concept that may never apply to you. However, the power of compounding makes it crucial to start saving at a young age. Even if you think you have years ahead of you to start saving, contributing a small amount at a young age can grow to a large nest egg by the time you start taking retirement withdrawals. Time may be your greatest asset, and failing to save now will mean you’ll have to contribute much more in the future just to attain the same amount.

Consider the previous example — if you started saving at age 28, you would eventually end up with over $40,000 by age 48. However, to end up with the same total savings at age 48, you would only need to contribute $5,740 if you started at age 20. And, if you contributed the same capital of $10,000 at age 20, your net savings at age 48 would be almost $70,000.



Continue to contribute

The net savings in the previous examples become even more impressive when you consider that you didn't have to contribute any additional principal to the account to earn them. However, it's likely that you contribute to your retirement account on a regular basis rather than as just one initial investment. These regular additions to your retirement account, combined with the power of compounding, can help your account grow even faster.

For example, if you made that initial investment of $10,000 at age 28 and then continued to contribute just $50 per month, instead of having $40,064 after 20 years, you would have nearly $65,000. If you automate your contributions from your paycheck and are paid twice a month, that means losing just $25 per paycheck would eventually help you save almost an additional $25,000.

Be patient

Compounding only works if you allow your investment to grow — taking the earnings from your investments rather than reinvesting them will defeat the purpose. Although the results may seem slow at first, they grow with time. If you have automated contributions set up, one of the best things you can do to allow compounding to work is to forget about it. If you're constantly checking to see how fast your money is growing, it may make you more impatient and more likely to want to withdraw your money for other purposes or move it into a more risky investment. Allowing compounding to work over time puts your money to work for you and results in a much larger account balance when you choose to retire.

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