



## Fact Sheet – Compounding

### What is compounding?

Compounding is the process by which interest is earned on interest. When a principal amount is invested, interest is earned on the principal during the first period or year. In the second period or year, interest is earned on the original principal plus the interest earned in the first period.

### Why is compounding important?

The extremely wealthy banker, Baron Rothschild, is credited with the statement that "compound interest is the eighth wonder of the world." However, the power of compounding is often overlooked. Compounding illustrates the "time value of money." The longer an investment is allowed to accumulate, the greater the effect compounding will have on its growth.

The principle of compounding is so crucial for us to understand because the earlier we are able to start saving and investing, the more benefit will be gained from earning interest on interest each year.

### What's an example?

There are three variables with compounding:

1. **Amount** - dictated by your ability to spend less than you earn.
2. **Interest rate** - a small increase over many years can significantly improve results but remember risk and return are related.
3. **Time** — it is "**Time In** the market" not "**Timing** the Market" that counts.

The table below demonstrates how an investment of \$1,000 each year grows at various interest rates. As can be seen from the table the rate of return has a significant impact. An increase of 2% can almost double the amount saved over 40 years.

Interest	5 Years	10 Years	20 Years	30 Years	40 Years
6%	\$5,975	\$13,972	\$38,993	\$83,802	\$164,048
8%	\$6,336	\$15,645	\$49,423	\$122,346	\$279,781
10%	\$6,716	\$17,531	\$63,002	\$180,943	\$486,852
12%	\$7,115	\$19,655	\$80,699	\$270,293	\$859,142

The earlier you start the greater the benefit. Using the 10% rate of return in the example above, if you wait one year before commencing you will accumulate \$45,260 less at the 39th year than a person who commence immediately and saved for 40 years. **Start saving now!**

### What are the drawbacks?

There are no real drawbacks to compound interest when talking about investing however the concept of compounding applies as much to investing as it does to borrowing, only in reverse. When we borrow money the effects of compounding work against us. That is why we recommend paying off debt as soon as possible, particularly high interest credit card debt and consumer debt.

### Is it biblical?

The concept of saving for the future is biblical (Proverbs 21:20 The wise man saves for the future, but the foolish man spends whatever he gets). However there are two important points to consider:

**Firstly**, we need to learn from the story of the rich man who tore down his barns and built larger ones to store his crops (Luke 12:16-21, 34). Jesus called him a fool because he was not generous toward God and others. We need to be generous in our giving and not hoard the resources God has blessed us with if we wish to please Him.

**Secondly**, there is no greater return than that provided by God (Mark 4:13-20). He can provide returns of 30, 60 or even 100 times what was sown. This equates to returns of nearly 3000%, 6000% and 10,000%. These may not be the worldly investment returns we relate to but they are the returns that really count.



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Financial Advice Based on Solid Foundations

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