Guide To…

Compound returns: the essential ingredient

If you start investing now, time can be a very powerful ally. Year after year, the money you invest earns more money. And if you reinvest your earnings, you can earn even more money in the future. It's called compounding returns and it's one of the keys to making your money work harder.

If you invest $1,000 at 10% p.a., you will receive $100 in interest during the first year. But if you reinvest your interest, you will have $1,100 working for you in year two. If your investment then earns another 10%, your interest will come to $110 in the second year, and so on.

Over a period of several years, compounding returns can make a significant difference to your wealth. And the sooner you start investing, the more compounding can work to your advantage.

How does the strategy work?

For compounding to work its magic, you need to do two key things:

1. Reinvest your investment returns

(e.g. dividends and interest), rather than spend the money on other things. This will enable you to turn your investment earnings into capital so that you can generate even more future earnings. An easy way to reinvest income is to participate in a dividend, interest or income reinvestment scheme.

2. Give your investment time to grow by

Starting your investment as soon as possible and keep it going for as long as you can. For example, if you invest $10,000 at an 8% annual return until age 65, the table below shows how much you would get back.

Age when you started the $10,000 investment:

20yrs	30yrs	40yrs	50yrs
$319,204	$147,853	$68485	$31,722

Note: This example ignores the impact of tax on investment earnings or inflation.

By simply investing ten years earlier, you could more than double your money. A case of delay and you pay!

The rate of return that your money earns can also make a big difference if you leave your money to compound over longer time periods.

Tips and Traps

- To maximise the benefits of compounding, it's important to give your investments time to grow. This could involve investing from an early age where you may be able to take advantage of lower financial and family commitments. Alternatively, you could consider deferring your financial goals to increase your investment time horizon.
- Consider increasing your regular investments as your disposable income rises. The compounding effect of making additional contributions will assist you in generating long-term wealth.
- Before embarking on an investment program, it's important to seek financial advice to ensure that your mix of investments reflects your financial objectives, investment timeframe and attitude towards risk. It's also a good idea to review your financial plan annually.
- The income distributed by a unit trust is taxable in the hands of investors regardless of whether the income is received directly or reinvested to buy more units. To minimise the amount of tax payable, you could consider holding the investment in the name of a low-income spouse (see Strategy 5) or using a discretionary trust.

The benefits

- Build wealth by reinvesting the income from your investments.
- Maximise the potential return by giving your investments time to grow.

If you have any queries in relation to the content of this material, please do not hesitate to contact Kate Kimmorley the Principal Financial Adviser at Kimmorley Financial Management on (07) 5591 1725.

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