

Saving and the Power of Compounding

In my last article dated February 22nd 2007, I gave you some general guidelines for setting up your personal budget and spoke about the importance of managing your money! I hope that you have been following my advice and that you are now ready for the next chapter in financial planning- Saving!

We all know that we should save...but how many of us actually practice the habit? Well, if you have not already started-it is never too late but the earlier you start the better! The first thing you need to do is condition your mind and there is no better way to do this than by setting a goal! Think about something you want to achieve in the future, it could be in the short term, the long term or both. Once you have your goal or goals in mind I suggest that you write it down on a piece of paper- there is a saying that "a goal not written down is only a dream!" Next to your goal, put the time frame for achieving your goal and the dollar value you would like to achieve. It should look something like this:

Goal 1:

Buy House- 10 years- down payment of \$200,000.

Now you have some motivation and with some discipline and sacrifice you are well on your way to achieving that goal! In the next few paragraphs I will outline some strategies or tips for saving and show you how the power of compounding can work the magic necessary to make those figures multiply!

As I mentioned in my previous article: it is a general rule of thumb that you should try to save at least 10 per cent of your income. However, if you can't afford that right now then work with what you can- you will get there eventually! Once you have established your contribution to savings, the next step is to make this automatic and mandatory. Set up a standing order or direct debit that transfers your savings from the time the money enters your current account. If you treat your savings like another expense you won't miss that extra cash- out of sight, out of mind! Leaving it up to yourself to manually transfer the money can lead to the temptation of spending it on some miscellaneous item.

Another useful tip would be to put most or all of any unexpected income into your savings pot. This may include: bonuses, salary increases, tax refunds, overtime pay or any other form of inflow. These extras would help to fatten your savings without any additional cutbacks or changes in lifestyle.

Credit card debt is one of the leading causes of financial distress-don't we know it!! In fact, any type of debt that is not properly managed can lead to financial distress. So, while it is wise to save, it does not make sense to do so when you are using high interest loans to cover your living expenses. The interest paid on savings is usually far less than the interest charged on borrowing, so pay off your debts first. Controlling and managing your debt is an important strategy for increasing your ability to save.

Another way of making your debt obligations work for you in achieving your financial goals would be to continue making payments even when the loan is paid off. However, instead of making these payments to your debt provider send these payments straight to

your savings account or investment vehicle. Once again, you will not miss the cash, because you would have grown accustomed to not having it and your disposable cash will remain unchanged.

How many times do we start sentences like: “I need to ...” or “I must ...” or “I really have to ...”. Sometimes our desire for something is so strong that we make it into a necessity rather than a want. The only things we really need are: food, clothing and shelter, since these are the basic necessities for us to live. A want on the other hand is something that improves or enhances our life style. The point here is that we often buy things that we don’t really need and this has the effect of lessening the money we have left over for saving. I am not saying that we can’t indulge or splurge at times; however we must have our priorities in order. Once we have satisfied all of our commitments (and this includes savings) then any extra cash can be used to extinguish those desires! Remember, saving is about sacrificing current expenditure so that we can achieve those goals that we have set for the future!

The strategies mentioned above are more or less the major ones for ensuring that you stick to your savings plan. However, there are many other useful tips such as shopping around for the best prices; cutting back on entertainment bills by eating at home more often; renting movies instead of going to the theatre; making a list when going to the grocery or shopping to avoid buying unnecessary items; conserving electricity and water to cut down on utility bills...and many more. Another option would be to contact a financial advisor who is experienced in this field and who will be able to sit down and go through ways in which you can cutback to save more.

By now, I hope I have encouraged some of you to get started; however there are a few who would still need some convincing and I have just the right thing. Referred to by Albert Einstein as the “eighth wonder of the world”- the power of compounding is an investor’s best friend.

When you save, the bank or financial institution adds interest to your savings at regular intervals whether it is monthly, quarterly or yearly. If you leave the interest and let it add to your lump sum, then you start to earn interest on your interest, as well as on the original amount you saved. This is called compound interest and the more frequently it is compounded the faster your balance grows. Also, the longer you leave your money, the more powerful the compound interest effect.

See Table 1 which illustrates the effects of compound interest over a 40 year period, where \$1,000 is saved each month and interest is calculated at a rate of 6 per cent compounded quarterly.

From the table you will see that after putting aside \$480,000 in total savings over a 40 year period, this happy investor, through the benefits of compounding will walk away with close to \$2 million dollars if he decides to do so. You can also see clearly the powerful effect of leaving the savings in the pot for longer. So, what are you waiting on? Don’t you want to buy that house?

Table 1

Year	Amt Invested (\$)	Interest to date (\$)	Total (\$)
1	12,000	273	12,273
2	24,000	1,299	25,299
3	36,000	3,124	39,124
4	48,000	5,797	53,797
5	60,000	9,371	69,371
10	120,000	42,804	162,804
15	180,000	108,644	288,644
20	240,000	218,133	458,133
25	300,000	386,409	686,409
30	360,000	633,865	993,865
35	420,000	987,962	1,407,962
40	480,000	1,485,692	1,965,692