Give yourself the gift of compounding

Make compounding an integral part of your strategy. The trick is to allow the returns to earn returns over time

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Who would not like to have an investment genie that makes your money grow? It is freely available to everybody and easy to use. It is called compounding. Say, if you invest just ₹2,000 each month (probably the cost of a family movie outing) in an investment which gave you a return of 8%, in 25 years, when you are ready to retire, this would be worth ₹20 lakh. Your contribution of only ₹6 lakh spread over 25 years has more than tripled in this time. All you did was let the money remain invested and the magic of compounding did the rest. Instead, if you had withdrawn or used up the interest from the investment as and when you earned it, you would have earned just over ₹6 lakh as returns over 25 years.

Get time on your side

The trick to earning compounded returns is to allow the returns to earn returns over time. The principal amount on which return is earned keeps increasing from one period to the next, as returns earned and any additional investments made add to the base amount. This makes the value of your investment grow faster with each passing period. "The more time you give your investments, the more you are able to increase the income potential. So, the earlier you start the better. Compounding also allows you to participate in market cycles without the risk of timing your entry and exit," said Bengaluru-based financial planner, Anil Rego.

What you need for compounding benefits to kick in is time and patience. If you give enough time, the contribution that compounding makes to the final value of your investments will be more than the amount you contributed. In the earlier example, out of the final value of ₹20 lakh, only ₹6 lakh was your contribution; another ₹6 lakh was the interest earned on your contribution; but ₹8 lakh was the result of compounding.

Compounding plays a crucial role in long-term investing. If the holding period of the investment comes down, contribution of compounding to the total returns will not be as significant and you will have to contribute more to reach the same value. In the earlier example, if you had delayed starting your investments by 5 years, you would have to contribute ₹3,250 instead of ₹2,000, or 60% more, to be able to reach the same ₹20 lakh in the time remaining. The sooner you start the lesser you need to invest since compounding will also contribute significantly to the final value of your investment.

Though there is no thumb rule as to when you should start investing, financial advisers say that whenever someone starts earning, she should keep aside some amount to invest. "Ideally, one should look to set aside at least 30% of the income for investing. Even if you get a starting salary of, say, ₹30,000 a month, you can keep 30% of this, or ₹6,000 as savings every month. This leaves you with enough money for monthly expenses," said Suresh Sadagopan, a Mumbai-based financial planner.

Choose to periodically invest regular savings, however small, instead of waiting to accumulate a large amount.

Let the money work

You would have seen compounding in action in investments such as the Public Provident Fund (PPF) that require periodic investments which are then locked away. In PPF, the relatively small investments that you make each year grow to a large value at the end of 15 years since the returns are not withdrawn but earn cumulative returns over the period. With a little discipline, you can structure your other investments to replicate these features essential for compounding to work.

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Begin by clearly identifying the investments that are earmarked for your long-term goals and those from which you don't need immediate or periodic payouts. Use the convenience offered by the in-built feature for re-investment that many investments provide. "Bank fixed deposits (FD) come with a rollover feature. When you opt for this, once the FD matures, it will be renewed for the same term forward. This makes reinvestment simpler," said Sadagopan.

Bonds too have the cumulative option, which re-invests the interest you earn into the same investment. The maturity value will have the compounded returns over the period. If the bonds or debt investments are of short tenors, then have the discipline to re-invest the maturity proceeds as soon as they mature so that there is no down time on the investment.

Equity will give you compounded returns if you remain invested and re-invest the dividends received . You should also make periodic and regular investments to absorb market volatility, and to benefit from compounding by increasing the base on which the returns are earned. Book profits if the valuations so indicate, but ensure that you re-invest the proceeds without delay into other equity investments or other assets.

If you are investing through mutual funds choose the growth option or dividend re-investment option to make sure that your returns remain invested and have a chance to compound, and use systematic investment plans (SIP) to make regular investments. SIPs are the most appropriate route for lay investors. "SIPs instill discipline and prevent one from simply chasing the markets," said Rego.

Till recently even equity-linked savings schemes, which are tax-saving funds, used to offer a dividend re-investment option. But no more because the lock-in period of three years meant perpetual reinvestment.

Re-invest to diversify

While reinvestment is good, doing so in the same product brings with it the risk of concentration. You will be holding more and more of the same asset and if the investment under-performs, a large portion of your money will be at risk. Diversification will reduce this risk. "Different asset classes have different benefits. Investing in different assets will help you ride market cycles better, and also balance out your risk profile," said Sadagopan.

For example, the interest from bonds can be re-invested in other bonds or even equity. You can book profits in equity investments and re-invest in other stocks or sectors. Or, you can choose the dividend payout option in a mutual fund and invest the dividend in other schemes of the same or different mutual fund. You may have to set in place some systems for this to work smoothly. For example, have a designated bank account to receive dividends, interest and redemption and sale proceeds from investments which you should immediately reinvest according to a pre-defined plan.

Investments such as mutual funds have facilities such as systematic transfer plans, switch and dividend transfer plans that automate the process of investing the proceeds from one mutual scheme to another.

But before you reinvest, "go back to your asset allocation and see if the product that you are going to reinvest in, fits in. Also look at the landscape of the investment, i.e. how the markets are doing," said Rego.

We tend to brush aside compounding because it takes time to show its benefits. But do remember that the power of compounding is more visible towards the latter half of an investment period. "In the short run, returns from a staggered investment may be lesser than a lump sum one, but in the long run, it definitely scores over a one-time investment," said Rego.

Once you are convinced about the pot of gold at the end from compounding, you will make the effort to choose your future needs over consumption today, and remain invested.

So make compounding an integral part of your investment strategy. The outcome will be an investment portfolio where your money works hard for you.

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