Capturing investors' interest

It may have taken a brilliant mathematician, such as Albert Einstein, to declare that "compound interest is the eighth wonder of the world" but it took a brilliant investor, Warren Buffett, to prove the theory in all its wonderful glory.

Mr Buffett, one of the canniest investors around, explained that his "wealth has come from a combination of living in America, some lucky genes and compound interest".[1]

While many of us cannot rely on living in the US nor be born with gold-plated DNA, we can aspire to growing our wealth using compound interest.

It works by adding to your savings with regular interest payments that merge with the original deposit, so the next time interest is paid, it is on the total sum – the original deposit plus previously earned interest. This pattern continues and compounds as long as withdrawals are avoided.

For instance, $2,000 invested at 5 per cent will be worth $2,100 a year later. Keep the deposit intact and the following year that $2,100 earns another 5 per cent and grows to $2,205. After 15 years, the compounding interest has doubled your money to more than $4,150.[2]

Adding deposits over time turbo charges compound interest

Naturally, the greater the rate of interest you are paid, the bigger the multiples of compounded value over time. If you are lucky enough to attract 10 per cent interest, a $2,000 deposit would more than quadruple to $8,354 after 15 years.

Currently, in these times of Reserve Bank of Australia induced low interest rates,[3] a standard savings account is unlikely to deliver enough income to keep deposits ahead of inflation.

However, as your financial planner, we can advise you on other types of savings strategies with greater compounding qualities to fulfil your future wealth ambitions.

With the right investment, a 30-year-old putting $1,000 away at 8 per cent interest could collect more than $14,000 on retirement without ever having added to the original deposit.

Even at half that interest rate, making an initial deposit of $1,000 on the birth of a baby and then $20 a week thereafter would, with compounding interest of just 4 per cent, deliver almost $30,000 by the time the child is 18 – enough to buy a car.

That is the wonder of compounding interest – the ability to effortlessly multiply savings over time. If you have a savings target in mind, speak to your financial adviser to help you put the right building blocks in place.

1 My philanthropic pledge, Warren Buffett, Fortune/CNN Money, 16 June, 2010, viewed 30 September 2013, http://money.cnn.com/2010/06/15/news/newsmakers/Warren_Buffett_Pledge_Letter.fortune/index.htm

2 About.com Mathematics, 2013, viewed 27 September 2013, http://math.about.com/library/blcompoundinterest.htm

3 'RBA keeps rates on hold at 2.5pc', Adam Creighton, The Australian, 1 October, 2013, viewed 1 October 2013, http://www.theaustralian.com.au/business/economics/rba-keeps-rates-on-hold-at-25pc/story-e6frg926-1226730893529