

Title:

Understanding Forex - #5 - Compound Interest.

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679

Summary:

This is a series of articles about The Foreign Exchange Market. You will learn here what Forex is , how it works and how profitable it can be. The whole series contain the following articles . . .

Keywords:

forex, forex market, forex strategies

Article Body:

This is a series of articles about The Foreign Exchange Market. You will learn here what Forex is , how it works and how profitable it can be. The whole series contain the following articles . . .

1. What is Forex
2. Technical analysis
3. Fundamental analysis
4. Money management
5. Compound interest

Compound Interest.

As an investor, time can be your best friend once you learn how to use compound interest to your advantage. This is an important aspect of any trading system. Compounding your profits can make you very wealthy and help you increase your investment profits exponentially.

The drawback of this technique is that you may also increase the risk. By reinvesting your gains you may multiply your profits but you can also suddenly lose everything.

I will explain here how compounding can make you wealthy. Also I will describe

some of the risks involved. This strategy may be suitable for some investors, but not for all. It is more like a long term strategy. Most traders or investors do not have the patience to undergo these kinds of strategies, but they could be quite profitable.

Remember this phrase: "Anything that can grow exponentially can explode." By explosion I mean here fast multiplication, quick rate of growth. The important word is exponentially.

If you could double your money ten times in a row, and you start with one thousand dollars, the tenth time you would be a millionaire. This means that if you invest \$1,000 and double, then you invest the \$2,000 and double it, then you do it again and again, you will be a millionaire by the time you double your money the tenth time.

Can you realize the power of compound interest? We are not talking about a specific time frame above, but the average amount of time that takes to double your money is very important. For example, if you can double your money every month and you start with \$1,000, it will take you less than a year to be a millionaire.

Some people try to do this at Forex, but it is very, VERY risky. There are other more conservative goals though. For example, if you could double your money (\$1,000) every 6 months, you would be a millionaire in about 5 years. If you could double your money (\$1,000) every year, it would take you about 10 years to be a millionaire.

Compound interest is one of the "secret paths" to wealth, but some people get greedy about it and lose their shirt. Also, there are some risks inherent on this technique that I will explain below. First let's describe the rule of 72 which is very important to understanding how compounding your profits work.

The rule of 72 is good for computing when your money will double at a given interest rate. If you want to find out how much would it take for your money to double, just divide the annual interest into 72. For example, if you get 12% on an investment and that rate stays constant, your money will double in $72 / 12 = 6$ years.

You can also compute the interest rate if you know how often your money will double. If you are told that your money will double every 5 years, the annual interest rate will be $72 / 5 = 14.4\%$. This is a rule of thumb. It gives approximate results.

Now, compounding your profits at Forex can be risky. You can use proper money management techniques, like those I explain on other article of this series, to control some of the risk, but not all. That's why it is important to never trade more than what you can afford to lose.

The important question is to define whether this strategy is suitable for you or not. That's up to you. Some traders and investors combine both, short term and long term strategies. They may also compound some of their profits.

Whether you compound your profits or not, that's your choice. My purpose on this article was to show you how important compound interest is and how profitable it can be. You can learn other trading strategies and aspects about trading Forex from my other articles.